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ABSTRACT

Fiscal year 1995 marks the first year during which an independent audit was conducted of the U.S. Department of Education's financial statements. This first annual accountability report describes the department's history, current mission, priorities, and progress. It highlights the department's program and fiscal accomplishments and describes future customer-service efforts. The report includes other reporting requirements on finance management: the overall condition of management controls, a progress report on audit followup, and a status report on the timelines of the department's vendor payments. The data indicate that the department has improved the control and accountability over student loan defaults, increased direct-loan program volume from 104 schools to approximately 1,350 schools, and initiated improvement to management processes. Six exhibits, three figures, the department's response to the audit, and the auditor's evaluation of department comments are included. (LMI)

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United States Department of Education

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Annual Accountability Report

Fiscal Year 1995

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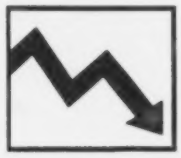
Prepared by the Office of the Chief Financial Officer

EA 028 177

Department of Education Fiscal Year 1995 Highlights

Improved control and accountability over student loan defaults

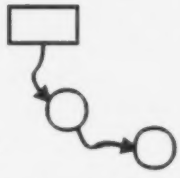


The net outlays for student loan defaults have dropped significantly from $1.7 billion in fiscal year 1992 to $500 million in fiscal year 1995. In fiscal year 1995, $2.5 billion was paid out to cover defaulted student loans while $2.0 billion was collected on previous loan defaults. The Department's focus on improving collection tools, accountability measures and oversight will continue this trend into the future.

Increased direct loan program volume from 104 schools to approximately 1,350 schools

The Department continued the successful implementation of the William D. Ford Direct Loan Program to assist postsecondary students and their families. The program, which began on July 1, 1994, represented 5% of loan volume in the 1994-95 academic year with 104 schools. For the 1995-96 academic year the Department successfully expanded the program to approximately 1,350 schools representing 35% of loan volume. Borrowers are offered a variety of flexible repayment options to help avoid defaults. Independent studies have determined both students and school administrators overwhelmingly approve of the program, aimed at reducing bureaucracy, reducing Federal costs, and improving service for both students and schools.

Initiated improvements to management processes to serve America's learners better



The Department has focused on improving processes to serve its customers better. The initiatives target streamlining programs, reducing paperwork, focusing on performance, and allowing internal and external customers to access the information they need. One example is an improved discretionary grant process reducing the number of process steps by 55% and improving communications with Department customers.

A longstanding and important role of the Department is to collect and disseminate information on education in America. Today, this role is carried out in part by the National Center for Educational Statistics (NCES), which publishes *The Digest of Education Statistics* and *The Condition of Education*. As part of this Annual Accountability Report, statistics from recent NCES reports are presented in the top page border.

U.S. DEPARTMENT OF EDUCATION

Fiscal Year 1995 Annual Accountability Report

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Education is a national priority as well as a state responsibility under local control.

UNITED STATES DEPARTMENT OF EDUCATION

THE SECRETARY

Dear Customers and Colleagues:

Fiscal year 1995 was a period of significant achievement for the Department of Education. We are proud of accomplishments in education programs, all of which demonstrate a strong emphasis on accountability for results and maximum flexibility in implementation. This vision of the Federal role recognizes that education is a national priority and a state responsibility under local control. Minimum regulation and maximum latitude define the Education Department's partnership with states and local communities and are the elements of success for a number of new programs.

The William D. Ford Federal Direct Loan Program simplifies and streamlines the Department's support for postsecondary education by making the loan process easier for schools and students. The new program provides a variety of repayment options. Along with changes in the older guaranteed loan program, direct lending is expected to save the taxpayers money, while providing better service to students and educational institutions.

The national cohort default rate in the Federal Family Education Loan Program dropped to an all-time low since reporting began. The cohort default rate has been cut almost in half, from 22.4 percent three years ago to 11.6 percent in the most recent year. The new cohort default rate is from fiscal year 1993, the most recent data available, representing borrowers scheduled to begin loan payments in fiscal year 1993 who defaulted either in that year or the following. The dramatic decline in default rates is coupled with an equally impressive rise in defaulted loan collections. Total collections for fiscal year 1995 were $2 billion; the Department's collections alone have increased fivefold since fiscal year 1993. These results are attributable in part to the Department's efforts to improve our accountability and gatekeeping functions.

The School-to-Work initiative jump-starts young people into thinking about their futures, and starting their careers off on the right foot. This program provides Federal seed money to states over a five-year period to get school-to-work programs off the ground. The Federal role is then phased out completely.

Finally, fiscal year 1995 was also a year that saw significant improvements in the management of the Department. The Department's strategic plan reflects our efforts to restructure the Federal role in education, focus on performance, streamline and reduce the number of education programs, and improve internal Department management. The inclusion of performance measures in the strategic plan holds us accountable for results.

There is every reason to be enthusiastic about the future. Education outcomes have been showing promising trends. We look forward to continuing to work hand in hand with states and local communities to serve the Nation's learners.

Dick Riley

Richard W. Riley

600 INDEPENDENCE AVE., S.W. WASHINGTON, D.C. 20202-0100

Our mission is to ensure equal access to education and to promote educational excellence throughout the Nation.

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF THE CHIEF FINANCIAL OFFICER

THE CHIEF FINANCIAL OFFICER

Dear Customers and Colleagues:

Fiscal Year 1995 marks the first year an independent audit was conducted of our Department-wide financial statements. We prepared these statements a year earlier than required under the Government Management Reform Act of 1994. Prior to this year, we had audits performed only on programs required to be audited by the Chief Financial Officers Act of 1990. These audits primarily covered our two principal student loan programs, the Federal Family Education Loan Program and the William D. Ford Federal Direct Loan Program. The Department-wide financial statements illustrate the Department's belief that we have the same financial management and stewardship responsibilities as private sector industries and we are accountable to our stockholders - the taxpaying public.

This first annual accountability report tells the Education story—our history, current mission, priorities and progress. More importantly, this report highlights our program and financial accomplishments and describes our future efforts to constantly improve how we serve our customers. Finally, this report includes other reporting requirements on financial management: the overall condition of management controls, a progress report on audit follow-up, and a status report on the timeliness of the Department's vendor payments.

I am pleased to present this report to the taxpayers in the spirit of public disclosure and accountability that is important to us at the Department of Education.

Mitchell L. Laine

Acting Chief Financial Officer

Department of Education's customers include over 50 million elementary and secondary students

600 INDEPENDENCE AVE., S.W. WASHINGTON, D.C. 20202-0100

Our mission is to ensure equal access to education and to promote educational excellence throughout the Nation.

Evolution of the Federal Role in Education

1862: First Morrill Act - Land grant program for state agricultural and mechanical colleges

1867: U.S. Department of Education founded to collect information on schools and teaching

1869: Roles transferred to Department of the Interior

1917: Smith-Hughes Act - Support for vocational education

1944: GI Bill - Educational assistance for veterans

1953: Roles transferred to Department of Health, Education and Welfare (HEW)

1956: Library Services Act - Grants to states for expanding and improving rural libraries

1958: National Defense Education Act- Strengthened instruction in science, mathematics and modern foreign languages

1958: Education of Mentally Retarded Children Act - Assistance for training teachers of the handicapped

1964: Civil Rights Act: Support for schools and colleges during desegregation

1965: Elementary and Secondary, and Higher Education Act - Grant and loan programs to support disadvantaged students

1978: Middle Income Student Assistance - expanded Federal financial assistance for higher education to middle income students

1980: Department of Education established

1986: Drug Free Schools Act - assistance to local communities in developing drug abuse education and prevention programs

1993: Student Loan Reform Act - Phased in direct lending program for higher education students

President Clinton: Education is "America's great energizer-the best change agent we can possibly have."

Secretary Riley: "Public education is one of the great essential building blocks of our democracy."

In 1993, 81% of the population age 25 and older had completed high school compared to 68% in 1980

Profile of the U.S. Department of Education

The U.S. Department of Education had its beginnings in 1867 with a budget of $15,000 and three employees to provide information to states to help them establish efficient school systems. This role has continued into and throughout this century and remains an important part of Education. As we approach the next century, the Department's support for learners in America remains a critical part of our Nation's success.

Education is a national priority as well as a state responsibility under local control. The nation spends more than $500 billion a year on education at the elementary, secondary, and postsecondary levels. State, local, and private expenditures account for about 90 percent of this spending, while the Federal government contributes about ten percent.

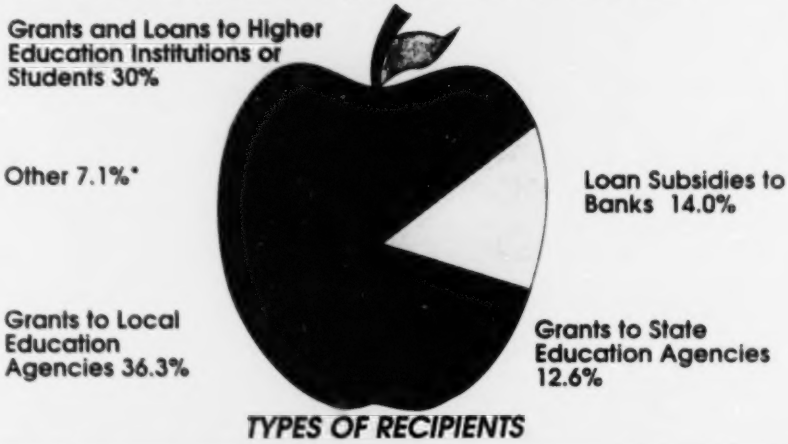
In Fiscal Year 1995, the Department administered $33 billion in education funding that was distributed to programs supporting students of all ages. This represents only about 2% of the total Federal budget. The Department of Education has six important areas of responsibility:

- Serving as a clearinghouse of good ideas and best practices in education around the nation
- Helping students and their families pay for college
- Supporting efforts by local communities and schools to boost student achievement for all students (including disadvantaged students)
- Assisting schools to prepare students for responsible citizenship, further learning and successful employment in a changing economy
- Providing national leadership and building partnerships in cooperation with states, communities, educators, parents, and the private sector—to address critical issues to improve American education
- Ensuring non-discrimination in education.

What Does the Country Get for Spending 2% of the Federal Budget on Education?

- The Department's elementary and secondary education programs annually serve about 15,000 local school districts and almost 50 million students attending approximately 84,000 public and 24,000 private schools
- Approximately 7 million postsecondary students receive grant, loan, and/or work study assistance each year through Department programs, which is about 1 out of 2 college students
- About 4 out of 5 disadvantaged elementary and secondary school students get extra help from the Department to learn the basics
- The Department assists 4 million adults annually to become literate and upgrade their skills

Where Do Department of Education Dollars Go?


Grants and Loans to Higher Education Institutions or Students 30%
Other 7.1%*
Loan Subsidies to Banks 14.0%
Grants to Local Education Agencies 36.3%
Grants to State Education Agencies 12.6%

TYPES OF RECIPIENTS

* Multiple types of recipients including Indian tribes and non-profit agencies.

Based on Department of Education Budget Outlays for Fiscal Year 1995 by Type of Recipient

Source: National Center for Education Statistics, Digest of Education Statistics 1995

Program Highlights and Performance

The Department's Mission and Strategic Plan

During fiscal year 1995, the Department produced its first comprehensive strategic plan. The plan reflects the Department's efforts to restructure the Federal role in education, focus on performance, streamline and reduce the number of programs, and improve internal Department management. Including performance measures in the strategic plan holds the Department accountable for results.

The Department's mission is "to ensure equal access to education and to promote educational excellence throughout the nation." Developing the next generation of Americans and the world's leaders is a clear national objective. The cornerstone of the future is a sound educational system that meets the far-reaching needs of all Americans, from elementary education through postsecondary and adult literacy and special needs. Department programs must be targeted and focused to assist state and local governments to carry out their educational responsibilities. To achieve this vision, the Department has established four strategic plan priorities.

The following table shows how programs were funded in the 1995 budget.

Mission Statement

To ensure equal access to education and to promote educational excellence throughout the nation.

Strategic Plan Priorities

#1 Help all students reach challenging academic standards so that they are prepared for responsible citizenship, further learning, and productive employment.

#2 Create a comprehensive school-to-work opportunities system in every state.

#3 Ensure access to high-quality postsecondary education and lifelong learning.

#4 Transform the U.S. Department of Education into a high-performance organization.

Department Programs Support America's Priorities for Learning

Major Programs	Budget ($ in millions)	% of Budget
Elementary & Secondary - Title I	$7,228	21.7%
Pell Grants	6,383	19.2%
Federal Family Education Loans	5,321	16.0%
Special Education	3,253	9.8%
Rehabilitation Services	2,393	7.2%
Vocational and Adult Education	1,388	4.2%
Campus Based	1,200	3.6%
Direct Student Loans	1,105	3.3%
Higher Education	919	2.8%
Impact Aid	728	2.2%
Professional Development	599	1.8%
Safe and Drug Free Schools	466	1.4%
Goals 2000	372	1.1%
Research, Statistics & Improvement	324	1.0%
School to Work	123	0.4%
Other programs	1,116	3.3%
Program Administration	*356*	*1.1%*
Total Fiscal Year 1995 Budget	**$33,274**	**100.0%**

Note: Program budgets represent funding Congress appropriated and will not necessarily match the expenses reported in the financial statements, since a program may not spend all funds during the year of appropriation. Because of rounding, details may not add to totals.

During fiscal year 1995, the Department began to set in place performance measures as an integral part of its strategic planning process in order to reform programs and the way in which it does business. The strategic plan includes goals, priorities, objectives, and performance indicators. Development of quantitative performance indicators is an ongoing process. To date, the Department has developed performance measures tied to objectives and priorities as defined in the strategic plan.

A sample performance indicator is included in the following discussion of each strategic plan priority. These, with the other defined indicators in the strategic plan, will be used to measure how the Department is performing in relation to defined objectives. Future accountability reports will include the actual performance the Department achieves in meeting the goals and objectives.

The public cited lack of discipline as the major problem facing local public schools in 1994, lack of financial support was the second major problem

Priority #1: Help All Students Reach Challenging Academic Standards so that they are Prepared for Responsible Citizenship, Further Learning, and Productive Employment

The Department is committed to helping state and local governments support elementary and secondary education. This assistance is primarily through grants targeted at high priority areas, accounting for almost $14 billion, or over 39 percent, of the Federal education dollar. This priority is to help all students and learners meet challenges and prepare for jobs. The major programs supporting this priority are described below.

Title I of the Elementary and Secondary Education Act supports the education of over 6 million disadvantaged children in more than 50,000 schools nationwide—about half the public schools in the country. The majority of the Department's support for this program is directed in the form of basic grants toward areas where high levels of poverty have contributed to low academic achievement. This program has improved the basic reading and mathematics skills of disadvantaged children in school districts across the country and helped close the learning gap between those children and more advantaged students.

Special Education programs assist over 5 million children with disabilities from birth through age 21 in meeting their developmental and educational needs. The Department's special education programs, delivered mostly in grants, assist states in providing early intervention services to infants, toddlers, children, and youth with disabilities in order that they ultimately achieve full integration and enjoy equal opportunity and access to education and employment.

Elementary and secondary education programs serve more than 108,000 public and private schools

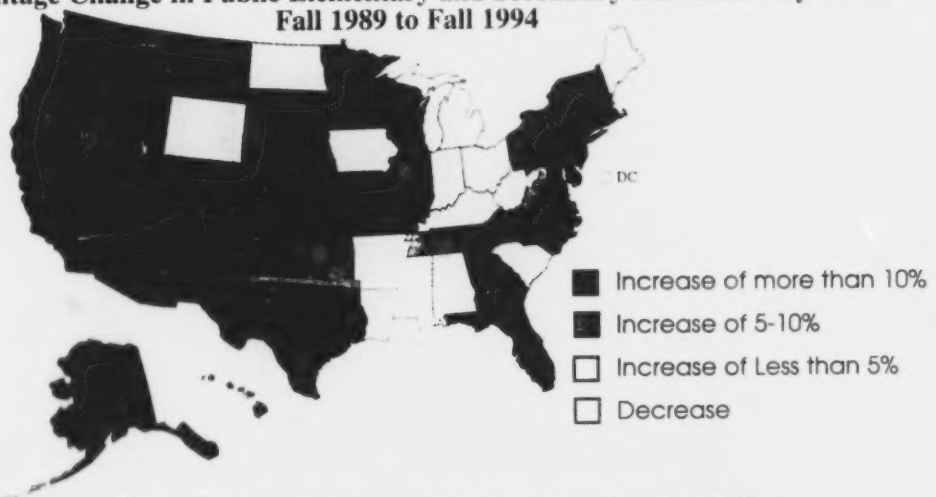
Rehabilitation Services and Disability Research programs provide assistance to one million adults with disabilities, most of them severe, in achieving successful employment outcomes and independent living. About 200,000 individuals with disabilities are placed each year in jobs in the competitive labor market or become self-employed. The Department administers these programs mostly through grants to states. States, in turn, develop, implement, and coordinate comprehensive programs of vocational rehabilitation and independent living for individuals with disabilities.

Vocational Education programs support training activities at both the secondary and postsecondary levels in accordance with state-developed plans. ***Adult Education*** programs provide assistance to approximately 4 million educationally disadvantaged adults to achieve literacy, certification of high school equivalency, and English language proficiency.

The Department's ***Impact Aid*** program provides assistance to states and local communities for whom Federal activities may present a hardship. The

Increasing Enrollments Emphasize the Continuing Need for Federal Support to State and Local Communities

Percentage Change in Public Elementary and Secondary Enrollment by State: Fall 1989 to Fall 1994



Source: National Center for Education Statistics, Digest of Education Statistics 1995

presence of a military base or Federal ownership of a significant proportion of local property, for example, may undercut the local tax base that ordinarily serves as the principal source of school funding. Impact Aid is intended to replace this lost revenue.

Professional Development funds support locally-guided teacher training in the core academic subjects. This investment is intended to ensure that teachers are prepared to teach to the high academic standards that states are now developing.

Priority #1: **Sample Performance Measure**

- The number of schools actively working to enable students to reach high academic standards will increase each year. The targets for school year 1996-97, is for as many as 20,000 individuals schools (about one quarter of the schools in the country) to actively participate in locally developed reform. For school year 1998-99 the target is 60,000 schools.

The **Safe and Drug Free Schools** program responds to the continuing crisis of violence and drugs in our schools by supporting comprehensive school- and community-based drug abuse and violence prevention programs. This program helps school districts to design programs to meet their own unique needs.

The Goals 2000: Educate America Act helps parents, teachers, and community leaders improve their own schools. This program provides great flexibility to schools, school districts and states to develop and implement actions locally.

The **Research, Statistics and Dissemination** functions are just as important now as they were at the time of the Department's inception. This area has historically assisted educators and academics who look to the Department for guidance and leadership on a national level.

Priority #2: Create a Comprehensive School-to-Work Opportunities System in Every State

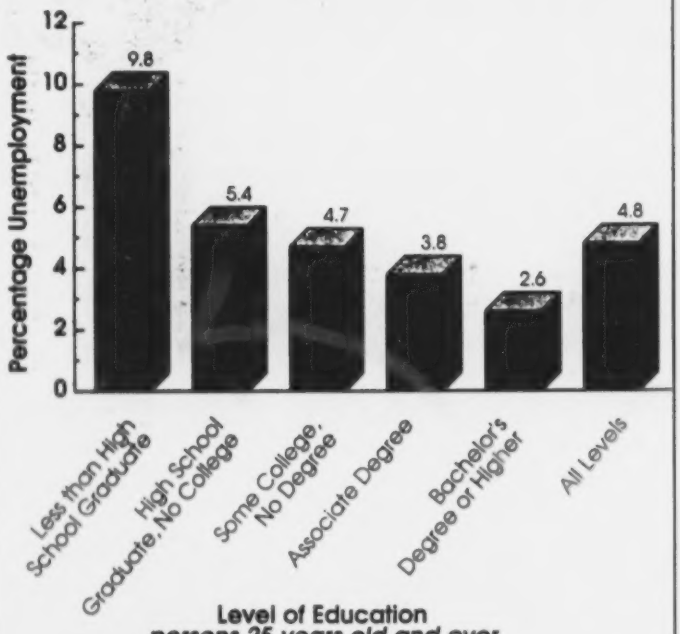
To prepare for the technology-oriented, highly competitive economy of the 21st century, the nation's young people will need a higher level of academic and occupational knowledge and skills. Today, too many American youth do not receive the education they need to successfully pursue postsecondary education and training in order to prepare for a career.

President Clinton made the development of a comprehensive ***school-to-work*** system for American youth one of the major goals of his administration. With bipartisan support in Congress, the School-to-Work Opportunities Act was signed into law May 4, 1994. A historic partnership between the Departments of Education and Labor is promoting the creation of comprehensive systems in every state.

The Department funded the School-to-Work program at $123 million in fiscal year 1995. While the funding level accounted for less than one percent of the Department's total appropriation for the fiscal year, the intent is to provide seed money to support school-to-work initiatives at the local level.

Education Drives Labor Force Participation

1993 Unemployment Rates by Highest Level of Education



Source: National Center for Education Statistics, Digest of Education Statistics, 1995

Priority #2: Sample Performance Measure

- By Fall 1996, at least 10,000 employers will participate in School-to-Work systems, by Fall 2000, at least 50,000 employers will be participating.

Priority #3: Ensure Access to High-Quality Postsecondary Education and Lifelong Learning

The single largest category of investment the Department makes with the Federal education dollar is in postsecondary education - helping families pay for college. Over $14 billion -- more than 45 percent of the Department's fiscal year 1995 appropriation--went directly to grants and loans in order that eligible students continue their education past high school. Viewed from another perspective, about 75 percent of all student financial aid in the nation is funded by the Department.

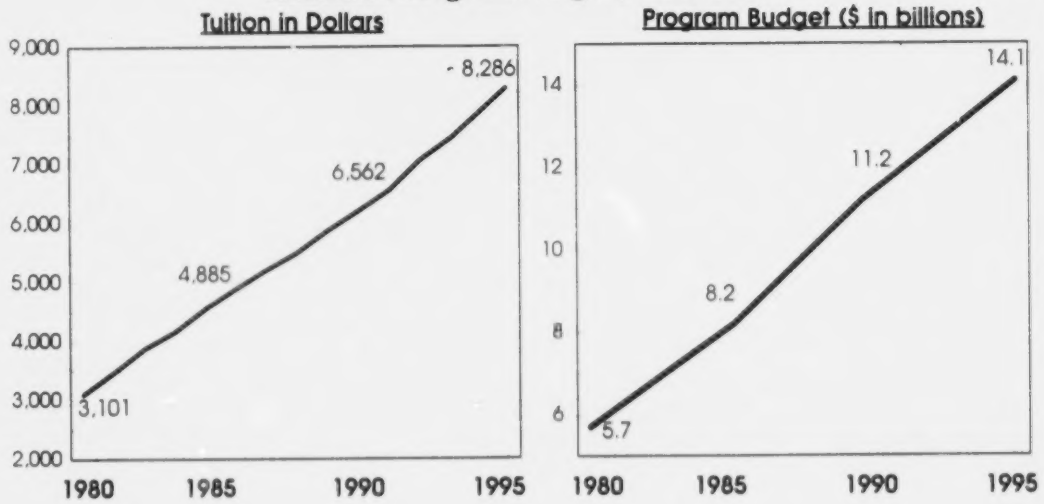
Department programs helped more than 7 million postsecondary students and their families pay for higher education in 1995

The ***Pell Grant*** program is the largest part of Federal student financial assistance. In fiscal year 1995, more than 4 million students received grants averaging more than $1,500. Most recipients of Pell Grants are from families earning less then $20,000 a year.

Two major student loan programs account for most of the remainder of the Department's support for postsecondary education. The ***William D. Ford Federal Direct Loan Program*** lends funds directly to college students. The direct loan program reduces bureaucracy and cuts out the "middlemen" in the student loan process while providing better service to students and schools. Various independent studies commissioned by the Department on Direct Loan participants concluded that both students and school administrators overwhelmingly approve of the Direct Loan Program. The program offers borrowers a variety of repayment options including standard repayment, graduated repayment, and income contingency repayment options. The income contingency repayment option enables borrowers to consider lower-paying public careers such as teaching and law enforcement. The second major student loan program is the **Federal Family Education Loan Program**, which since 1965 has guaranteed loans made to students by private lenders.

Federal Support Has Kept Pace with the Rising Costs of Higher Education

Average Undergraduate Tuition and Department of Education Postsecondary Education Program Budgets, 1980-1995



Tuition includes room and board
Source: National Center for Education Statistics, Digest of Education Statistics 1995

Together, these two loan programs currently make over $26 billion in loans to about 6.5 million postsecondary students and their families. Loan funds for the Direct Loan Program are provided by the U.S. Treasury. Private capital is used in the Federal Family Education Loan Program. Currently, over 80% of all student loans are repaid on schedule.

The Department's ***Campus Based*** programs provide assistance to institutions which enables them to provide students grants and low interest loans on the basis of need. **Higher Education** programs support development and strengthening of programs at institutions and direct grants and fellowships to students in a variety of programs.

Priority #3: **Sample Performance Measure**

- Customer satisfaction with the student aid delivery system as a whole and with its component parts will increase significantly.

Per pupil expenditures are projected to increase by 17% from 1993-94 to 2004-2005.

Priority #4: Transform the U.S. Department of Education into a High-Performance Organization

The Department is transforming its management structure and personnel practices to implement the best management practices of business and industry. The fiscal year 1995 budgeted administrative costs of $356 million are low; less than two cents of every Department dollar.

The Department has been aggressive in streamlining its services, reducing regulations, consolidating and eliminating programs, and lowering the student loan default rate.

The Department has supported and proposed legislation, or made policy changes which would save $16.7 billion between fiscal year 1995 and fiscal year 2000. These activities include reforms in postsecondary education lending, elimination and consolidation of education programs, and a substantial reduction in personnel. All of these cost-saving measures are under way and have already reaped benefits.

Priority #4: Sample Performance Measure

- By 1997, the number of steps in the discretionary grant process will be reduced by 50% and the time to process grants reduced by 25%.

Less than 2 cents of every Department's dollar is spent on discretionary program administration.

Financial Highlights

Fiscal year 1995 was a year of profound improvement in Department financial management. Student loan default rates dropped dramatically while collections steadily rose. However, some serious problems remain. Structural deficiencies in the Federal Family Education Loan Program continue to allow inaccurate financial information into systems. A limited number of ineligible recipients also still manage to receive financial assistance and the audit follow-up function has been taxed by additional audit requirements. Financial management systems infrastructure is also seriously inadequate. The Department acknowledges these problems with a firm commitment to continue devoting available resources to their speedy resolution.

The financial highlights presented below are only the first steps in a long-term effort to be more accountable for public monies, to be more responsive to customers and to effectively promote education improvements.

Student Loan Defaults and Collections

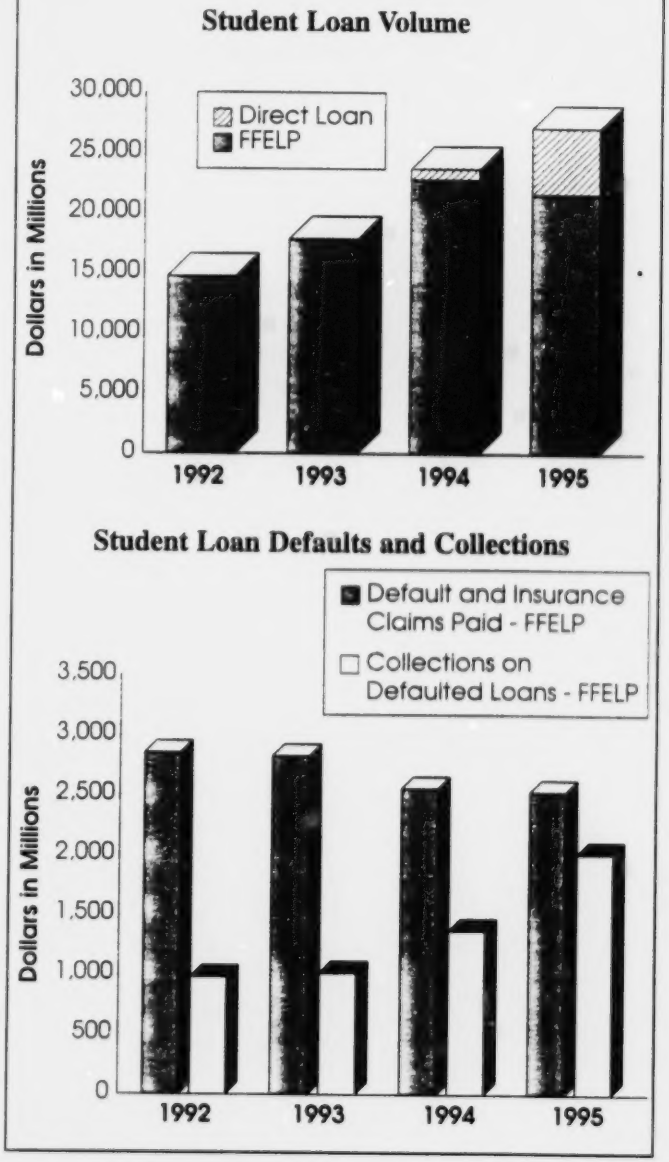
The Department's Office of Postsecondary Education has improved control over defaulted student loans resulting in both decreased defaults and increased collections, while loan volume grows. The national cohort default rate in the Federal Family Education Loan Program (FFELP) have dropped from 22.4% in 1990 to 11.6% in 1993 (the Direct Loan Program has not yet experienced significant defaults). This Office has continued its aggressive accountability and collection activities resulting in a near doubling of collections in 2 years to over $2 billion in fiscal year 1995. Defaulters face serious sanctions, including general income tax refund offset, wage garnishment, denial of further student aid, and loss of other forms of credit. The IRS tax refund offset program continues to be a major source of collecting defaulted loans. In fiscal year 1995, the Department collected $588 million from 778,000 individuals via the IRS program.

Controlling the participation of schools in the Student Financial Assistance programs is a key to controlling fraud and abuse, reducing loan default rates, and promoting quality postsecondary education. The Department has

taken a number of steps in recent years to improve its monitoring and compliance activities of institutions. During fiscal year 1995, two new administrative systems--the National Student Loan Data System (NSLDS) and the Postsecondary Education Participation System (PEPS) became operational. NSLDS should prevent ineligible students -- and students who provide false information -- from receiving funds. In the 1994-1995 school year, the NSLDS blocked the issuance of $230 million in loans to ineligible applicants. PEPS also aims at improving the gatekeeping functions over student financial aid. Its purpose is to maintain a database of institutional-level loan information that will confirm eligibility and monitor participation of postsecondary education institutions, lending institutions and loan guarantors.

Legislation has also played a vital role in improved performance by giving the Department broader authority to reduce risk and recover on defaults. The Higher Education Amendments of 1992 provided the Department a number of new authorities to deny schools eligibility to participate in Federal student aid programs if the schools have high default rates or other high risk characteristics. The Debt Collection Act, as amended, provided several new authorities to recover past due

The Department Continues to Improve Control Over Student Loan Programs



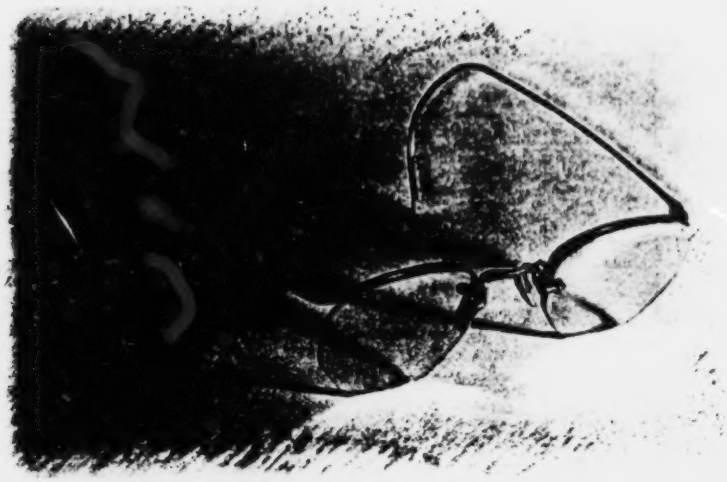
debts. These added authorities have enabled the Department to substantially increase collections.

Administrative Cost Reductions

As part of Priority 4: "Transform the Department into a high-performance organization", the Department has initiated several efforts to not only increase performance, but also to reduce costs associated with administrative activities. The benefits associated with these activities are quantifiable, as well as being sound management practices.

- The Department is participating in several programs that reduce the need for cash advances to travelers and the administrative costs associated with travel. In addition, by using the American Express Card and the Travel Management Centers the Department received over $130,000 in rebates during fiscal year 1995.

- One of the Department's goals is to reduce the number of purchase orders processed and increase usage of the International Merchant Purchase Authorization Card (IMPAC). The IMPAC card is a credit card carrying the VISA® logo. During fiscal year 1995, the IMPAC Card was used for 51 percent of all small purchase transactions ($25,000 or less), thereby eliminating paperwork associated with traditional procurement practices. This percentage will increase in fiscal year 1996 as the range of products and services procured by the card expands. The Department has also developed and implemented an automated system for reconciling the IMPAC bill, creating the payment and posting the



The Department is engaged in a long-term effort to be more accountable for public monies, responsive to its customers and to promote educational improvements.

expenditure to the accounting system.

- The Department has replaced burdensome process-oriented structures previously used to evaluate management controls with a streamlined results-oriented process. In meeting the Federal Managers Financial Integrity Act (FMFIA) reporting requirement for fiscal year 1995, the Department put in place a structure that encourages ongoing oversight and emphasizes shared responsibility at the highest levels of management. Equally important, the streamlined process will save approximately $1 million per year due to decreased paperwork.

The streamlined FMFIA process will save approximately $1 million due to reduced paperwork.

- An accounting and financial management curriculum was developed by the Department to meet the various needs of financial managers, accountants, and program managers within the Department. The curriculum emphasizes financial management and stewardship responsibilities inherent in every job.

- Future financial management initiatives include implementing the Third Party Payment System, an automated system that will enable employees to make selected payments using draft instruments in lieu of cash and government checks. This system allows the Department to issue draft/checks directly to employees. This system is expected to save the Department in excess of $250,000 during a fiscal year.

Financial Performance & Process Improvement Initiatives

The Department is committed to improving financial performance and has taken several significant steps to ensure that funds are spent effectively and efficiently. This section highlights improvement initiatives and actual performance to date. These activities include cash management efforts, the integration of financial systems, improved payment processing, grants reengineering and electronic commerce.

Education's Central Automated Processing System (EDCAPS)

The Department is investing in tighter, more efficient management of tax dollars by upgrading its financial management systems and automating manual procedures. This major investment in EDCAPS will replace three major financial systems and numerous supporting systems with a fully integrated financial management system. EDCAPS will contribute to the Department's ability to serve customers by (1) providing timely responses to customer inquiries, (2) empowering employees to make informed decision by increasing their access to data, and (3) increasing accountability through improved financial management. EDCAPS will implement three primary business processing modules, each with a similar look and feel, and all accessible under the same EDCAPS group of business process activities. All modules will manage information from a common relational database, and use state of the industry reporting tools for quick, easy access to information. The improved data integrity and reporting capabilities will be a breakthrough for the Department's recipients in their participation in Federal education programs and to the Department's managers who will have accurate information when they need it.

EDCAPS

During fiscal year 1995, high-level requirements analyses were conducted to support EDCAPS functions and all contracts supporting individual module development have been awarded. Commercial Off-The-Shelf software was acquired for two modules to provide the most expedient and cost effective solutions available. A separate

grants and payment module will be developed and integrated with the two other modules. EDCAPS is expected to be fully operational in Fiscal Year 1998.

Cash Management Improvement Activities

States are charged interest on excess Federal funds held in their private bank accounts. States also submit reimbursement claims for interest owed them because the Department was late in sending funds thereby requiring the States to use their own funds. For fiscal year 1995, the States' liabilities from interest earned on excess Education funds was $5.2 million while they claimed interest of only $2.5 million being owed by the Department. Hence, due to the Department's prompt delivery of funds to States, the Federal Treasury was entitled to receive over $2.7 million.

Government-wide Performance Measures

The Executive Office of the President's Office of Management and Budget has established 5 performance measures for Federal agencies' financial performance. The Department compares favorably with these measures.

- Integration of financial managements systems - The Department will be in compliance with this measure and will fully implement the Standard General Ledger with EDCAPS implementation.
- Timeliness of vendor payments by Federal agencies - The Department paid 95.6% of its vendor payments on time, or without penalties during fiscal year 1995.
- Audited financial statements - This Annual Accountability Report presents the Department's first Department-wide audited financial statements, one year ahead of the legislative requirement.
- Growth in debt collection tools - Department and guaranty agencies collected $2 billion in defaulted loans, a 25% increase from fiscal year 1994 collections of $1.6 billion. The Department continues to use debt collection tools including: administrative offset, litigation, Federal employee salary offset, private collection agencies, and tax refund offset.
- Trends in receivables & delinquencies - The Department's total receivables increased to $6.9 billion in fiscal year 1995. This increase was compensated with increased collections for fiscal year 1995.

Grants Reengineering

A reengineering effort aimed at the discretionary grants process in fiscal year 1995 confirmed a business process laden with unnecessary layers of review and a cumbersome flow of documents that caused delays in processing and impaired communication. Streamlining the current process in fiscal year 1996 will reduce the number of process steps by 55%, saving time and resources. The new redesigned process will build on these accomplishments and proposes decentralizing many of the administrative grant functions to the various program offices. The initiative will enhance customer service by increasing efficiency and improving communications.

Electronic Commerce

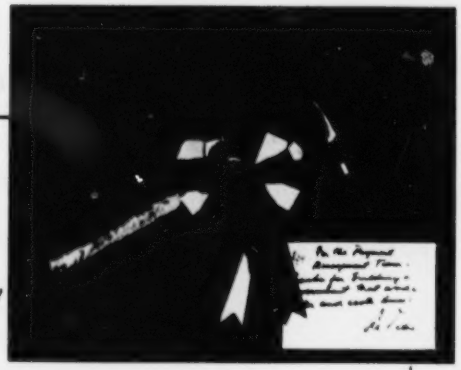
The Department is committed to electronic commerce and other new technology advances. During the year, the Department teamed with the Department of Agriculture, developed, and implemented a system to electronically request and award contracts. As a result, this pilot phase of electronic commerce saved the Department $38,323 in August and September 1995. The use of electronic commerce will expand during fiscal year 1996.

The Department is committed to electronic commerce and other new technology advances to increase efficiency and reduce cost.

Cooperative Audit Resolution and Oversight Initiative

The Department has reexamined its relationship with state and local education agencies and redefined its role in conducting audits. The product of these efforts is a new spirit of teamwork, an audit approach that treats each case individually, and an emphasis on resolv-

ing issues on a cooperative basis. The new process links technical assistance, monitoring and oversight to specific audit issues in a manner that promotes improved program performance. State and local education agencies, the Department, and most importantly, the nation's learners all benefit from this initiative.



Hammer Award - Improving Payment Processing

The Payment Management Team in the Office of the Chief Financial Officer received the prestigious Hammer Award in fiscal year 1995 for their improvements in customer service. The Hammer Award is given by the Office of the Vice President to teams that exemplify the principles of reinvention. The Payment Management Team initiated and implemented three technologically advanced solutions that address customers' needs:

(1) Enhanced and implemented a new electronic filing of recipient cash expenditure reports eliminating the need to complete reports manually and transmit them by mail.

(2) Installed a new interactive voice response system for recipients which allows callers to receive information about their accounts simply by placing a telephone call, and

(3) Automated the intensely manual payment process.

These three reforms enabled the Department to provide its recipients with funds more efficiently, accurately, and expeditiously. The initiatives also shifted the responsibility and accountability for fund transactions into the hands of the recipients. The Department has automated the entire grants payment process from recipients requesting payment to funds delivery. For fiscal year 1995, $28 billion dollars was provided in grants payments through electronic funds transfers. This represents over 217,000 separate transactions. The automation has virtually eliminated manual processing and drastically reduced the incidence of errors. Staff previously burdened with manual payment processing are focused on better serving customers rather than reacting to payment problems.

Highlights of Reporting Requirements

Federal Managers Financial Integrity Act

The Federal Managers Financial Integrity Act (FMFIA) requires agency managers to conduct regular evaluations of management controls with special attention to accounting systems to protect Federal programs from fraud, waste and mismanagement. FMFIA compliance is embodied in larger efforts to reform management processes at the Department.

Five areas within the Department were designated as material management control weaknesses. The Department is near completion of implementing corrective actions aimed at addressing these material weaknesses.

FMFIA Compliance Status Matrix

Material Weaknesses		
Material Weakness	Year Identified	Year (to be) Corrected
Student Financial Aid: Institutional Gatekeeping	Fiscal Year 1989	Fiscal Year 1997
Office of Student Financial Assistance: Audit Follow-up	Fiscal Year 1991	Fiscal Year 1996
Office of Student Financial Assistance: Ineligible Pell Recipients	Fiscal Year 1994	Fiscal Year 1996
Office of Postsecondary Education: Data Quality to Support Management Decisions	Fiscal Year 1995	To Be Determined
Information Resource Group: ADP Inventory Control	Fiscal Year 1994	Fiscal Year 1996

The Department's accounting and financial systems generally conform to the Comptroller General's principles, standards and related requirements for accounting systems. However, four problem areas will be corrected in fiscal year 1996. The non-conformances are outlined in the following table.

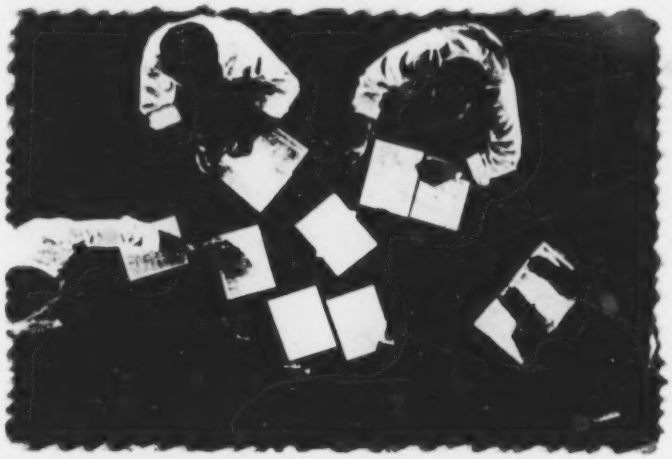
FMFIA Compliance Status Matrix

Material Non-Conformances
Federal Family Education Loan System and Primary Accounting System: - Inadequate accounting for loan losses, interest subsidies, and loan origination fees
Impact Aid System: - Inadequate controls over accounts receivable transactions - Lack of written systems procedures
Financial Management Systems - Inadequate data sharing

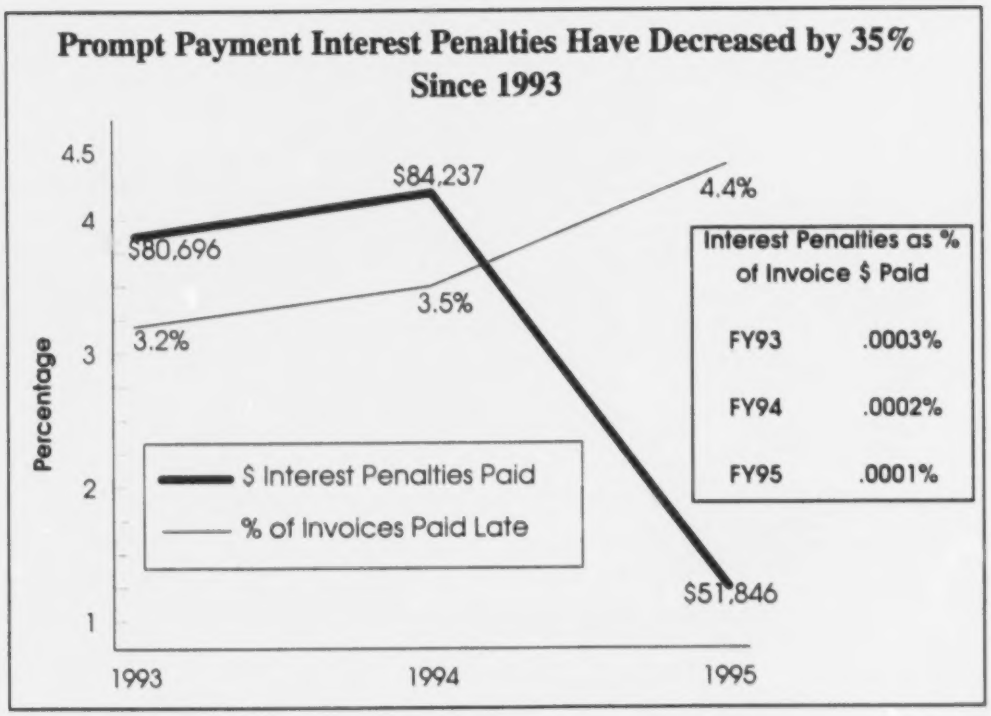
Management Response to Semiannual Report to Congress on Audit Follow-up

The Inspector General Act Amendments of 1988 require departments to submit semiannual reports to Congress regarding management actions taken in response to Office of Inspector General (OIG) audit recommendations. Audit follow-up activities at the Department are the responsibility of the Chief Financial Officer, who ensures that timely responses are made to all audit recommendations and that appropriate corrective actions are taken.

In fiscal year 1995, the Department completed action on 882 audit reports with disallowed costs, collecting or receiving promissory notes of $4.8 million. Also during the reporting period, the Department took final action on 34 additional audit reports which improved use of almost $229 million in Federal funds by educational institutions and state entities.



The Department is working to address the FMFIA weaknesses and non-conformances.



Prompt Pay

The Prompt Payment Act requires that agencies report annually on the status of payments subject to the Act. Virtually all of the Department's payments subject to the Act are made through the Department of Agriculture's National Finance Center in New Orleans, Louisiana. The Department's prompt payment performance for the last three years shows a pattern of improvement. Even though the percent of invoices paid late increased slightly during the year, both the dollar interest paid and interest penalties paid as a percentage of total dollars paid decreased. Increased use of computer based purchases, electronic commerce, and government charge cards, coupled with solid cash management practices, have brought about substantial reductions in total interest penalties paid for fiscal year 1995, down to $51,846 from $84,237 in fiscal year 1994.

Financial Statement Presentation

The financial statements have been prepared to report the financial position and results of operations of the Department of Education, pursuant to the requirements of the Chief Financial Officers Act of 1990. While the statements have been prepared from the books and records of the entity in accordance with formats prescribed by the Office of Management and Budget, the statements are different from the financial reports used to monitor and control the budgetary resources which are prepared from the same books and records.

It is expected that the development of the financial management systems, as well as the discipline necessary to prepare these statements, will lead to the production of more timely, reliable, and useful financial management information for use throughout the government.

The statements should be read with the understanding that they are for a component of a sovereign entity, that liabilities not covered by budgetary resources cannot be liquidated without the enactment of an appropriation, and that the payment of all liabilities other than for contracts can be abrogated by the sovereign entity.

The Department has prepared these Department-wide financial statements one year ahead of the requirement

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Independent Auditor's Reports

Audit Control Number 17-40303
June 1996

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

AUG 16 1996

Honorable Richard W. Riley
Secretary of Education
Washington, D.C. 20202

Dear Mr. Secretary:

These reports present the results of the audit of the Department's annual financial statement for the fiscal year ended September 30, 1995, to comply with the Chief Financial Officers (CFO) Act of 1990. The Department chose to produce financial statements at the Department level, one year ahead of the implementation date set by the Government Management Reform Act (GMRA) of 1994.

The Office of Inspector General (OIG) contracted with Price Waterhouse, LLP (PW), Certified Public Accountants, to perform the audit. The OIG monitored the progress of the audit, reviewed supporting working papers and performed other procedures deemed necessary to ensure compliance with the CFO Act of 1990.

The results of the audit were discussed with Department officials throughout the audit. The Offices of the Chief Financial Officer and Postsecondary Education responded to the findings and recommendations presented in the draft audit reports. Based on the response, management believes that the reported FFEL Program liability for loan guarantees is reasonable. Management is in general agreement, however, with most of the other issues in the reports. The complete text of the Department's combined response and PW's comments on it are enclosed.

During the course of the audit, PW identified other matters which are not reportable but nevertheless warrant management's attention. These are being communicated in a separate letter for management's consideration.

In accordance with the Freedom of Information Act (Public Law 90-23), reports issued by the OIG are available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

We appreciate the cooperation given us and PW during the audit.

Steven A. McNamara
Assistant Inspector General
for Audit

Enclosures

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Price Waterhouse LLP

REPORT OF INDEPENDENT ACCOUNTANTS

To the Inspector General
U.S. Department of Education

We were engaged to audit the accompanying consolidated statement of financial position of the U.S. Department of Education (Education) as of September 30, 1995, and the related consolidated statements of operations and changes in net position and cash flows for the fiscal year then ended. These financial statements are the responsibility of Education's management. As part of our audit we have issued separate reports dated June 4, 1996, on Education's internal control structure and on compliance with laws and regulations.

Certain financial statement amounts related to Education's Federal Family Education Loan (FFEL) Program either could not be supported with complete, accurate and reliable data, or differences existed between amounts included in Education's financial statements and underlying data that could not be explained. The historical loan data on which the FFEL Program's aggregate liability for loan guaranties of $12.9 billion was based, either contains errors or critical prior year data is missing. The lack of reliable and complete data prevents assessing whether Education's liability estimate is materially over or under stated. Receivables for defaulted loans reported in Education's financial statements were reduced by $888 million to write-off amounts by which Education's accounting records differed from those of guaranty agencies who perform collection services on Education's behalf. Officials from Education have asserted that based on a study conducted prior to fiscal year 1995, the amounts written-off resulted from problems in the automated system Education used to record collections on defaulted loans. However, Education was unable to provide documentary evidence to support this assertion.

Reserve funds of $1.8 billion maintained by guaranty agencies are reported in Education's financial statements as assets in accordance with The Higher Education Act Sec 422(g)(1). However these reserves are reported by Education using cash instead of accrual basis information received from guaranty agencies. Since The Higher Education Act considers reserve funds and any assets purchased with such reserve funds to be assets of the United States Government, we believe reporting reserves using the accrual basis of accounting would be more appropriate. However, there is no information to determine what aggregate reserve funds would be if the accrual basis of accounting were applied.

To a much lesser degree than the FFEL Program, there are other financial statement amounts for which unreconciled differences existed, or where potential errors identified by the single audit act process were not quantified. Education's account with the U.S. Treasury was out of balance with its accounting records by a net difference of $183 million. In the absence of information to explain what comprises this difference, we are unable to determine the effect, if any, on Education's financial statements if the $183 million difference contains errors. With respect to grant expenses, audits conducted on Education's behalf revealed, from time to time, that amounts were improperly granted, in which case Education could be entitled to recoup the funds. However, the results of these audits have not been summarized by Education, and we are unable to determine the effect on the financial statements, if any, that might result from potential misuse of grant funds.

As described above, certain amounts reported in Education's consolidated financial statements could not be supported by sufficient and reliable accounting information and certain differences between financial statement amounts and underlying accounting records could not be adequately explained. Because obtaining missing information or locating evidence to explain differences in the accounting records would have entailed reconstruction of a substantial amount of supporting data, it was not practicable for us to extend our auditing procedures to satisfy ourselves regarding the effect these matters might have on Education's consolidated financial statements. Accordingly, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying consolidated financial statements.

The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present financial position, results of operations and cash flows of Education's major programs and activities. For the reasons described in the preceding paragraph, we are unable to, and do not, express an opinion on whether such consolidating information is fairly stated, in all material respects, in relation to the consolidated statements taken as a whole.

The overview of Education contains a wide range of data, some of which are not directly related to the consolidated financial statements. We do not express an overall opinion on this information. However, we compared this information for consistency with the consolidated financial statements and discussed the methods of measurement and presentation with Education officials. Based on this limited work, we found no material inconsistencies with the consolidated financial statements.

Price Waterhouse LLP

Washington, D.C.
June 4, 1996

Office of Government Services
1301 K Street N.W., 800W
Washington, DC 20005-3333

Telephone 202 414 1000

Price Waterhouse LLP

REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

To the Inspector General
U.S. Department of Education

We were engaged to audit the consolidated financial statements of the U.S. Department of Education (Education) as of and for the year ended September 30, 1995, and have issued our report thereon dated June 4, 1996. In that report we disclaimed an opinion on the consolidated financial statements because certain amounts reported in Education's consolidated financial statements could not be supported by sufficient and reliable accounting information and certain differences between financial statement amounts and underlying accounting records could not be adequately explained.

Compliance with laws and regulations applicable to Education is the responsibility of Education's management. As part of our effort to audit the consolidated financial statements, we performed tests of Education's compliance with certain provisions of applicable laws and regulations. However, the objective of our tests was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of non-compliance that are required to be reported herein under *Government Auditing Standards*. The results of our tests disclosed immaterial instances of noncompliance with the above requirements will be communicated to management in a separate letter.

This report is intended for the information of the Inspector General, Education's management, and the Congress. However, this report is a matter of public record and its distribution is not limited.

Price Waterhouse LLP

June 4, 1996

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Price Waterhouse LLP

REPORT ON INTERNAL CONTROLS

To the Inspector General
U.S. Department of Education

We were engaged to audit the consolidated financial statements of the U.S. Department of Education (Education) as of and for the year ended September 30, 1995, and have issued our report thereon dated June 4, 1996. In that report we disclaimed an opinion on the consolidated financial statements because certain amounts reported in Education's consolidated financial statements could not be supported by sufficient and reliable accounting information and certain differences between financial statement amounts and underlying accounting records could not be adequately explained.

The management of Education is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that: (1) transactions are properly recorded and accounted for to permit the preparation of reliable financial statements and to maintain accountability over assets; (2) funds, property, and other assets are safeguarded from loss from unauthorized use or disposition; and (3) transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projections of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

We noted certain matters in the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Certain reportable conditions are also considered to be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more elements of the internal control structure does not sufficiently reduce the risk of material errors and irregularities occurring and not being timely detected. Material errors or irregularities are those that, in the judgment of independent accountants, might cause a large dollar impact in the financial statements being audited, or might be qualitatively important to a reasonable person relying on those financial statements.

Overview of Weaknesses

Fiscal year 1995 was the first year an audit was conducted of Education's consolidated financial statements. In prior years, separate audits were performed of the Federal Family Education Loan (FFEL) Program and the William D. Ford Federal Direct Loan (Direct Loan) program, as required by the Chief Financial Officers (CFO) Act of 1990. Pursuant to the Government Management Reform Act (GMRA) of 1994, financial statement audits will be required for all of Education's operations, beginning with fiscal year 1996. Education elected to begin the process a year ahead of time.

Most of the control weaknesses discussed in this report have been previously identified during prior audits performed by the Office of Inspector General and General Accounting Office, or in Education's report prepared pursuant to the Federal Managers' Financial Integrity Act. For most of these weaknesses Education has initiated corrective action plans. However, as of the completion of our audit, we found that the corrective actions were not sufficiently completed such that the control weaknesses could be considered corrected. Thus, we have continued to report the control weaknesses as material weaknesses or reportable conditions.

Presented in Exhibit 1, on page 3, is a summary of the material weaknesses and reportable conditions that we noted in performing our audit. These weaknesses are discussed in detail in the balance of this report.

Exhibit 1: Summary of Control Issues

Issue Area	Summary of Control Issues	Page Ref.
FFEL Program -- Liability Estimate for Loan Guarantees (Material Weakness)	Education is in the process of implementing its National Student Loan Data System (NSLDS) to augment data available in managing the FFEL Program, including the development of the estimated liability for loan guarantees. However, this new system is not yet populated with sufficient years of data; nor has system data been tested by Education to ensure the data is reliable. Because of these limitations in the NSLDS data, we are unable to conclude whether Education's liability estimate for fiscal year 1995 is materially correct.	6
FFEL Program -- Guaranty Agency Oversight (Material Weakness)	Education needs to finalize and issue improved audit guidance so that audits of guaranty agencies (GA) are more effective in ensuring the reasonableness of the $2.8 billion in cash outflows and $2.0 billion in cash inflows to Education. Education is unable to reconcile its loans receivable portfolio held by the GAs with GA records. An unexplained difference of $888 million has accumulated over many years of the program's operation. Education needs to improve control over its $1.8 billion in cash-basis reserves held by the GAs.	12
FFEL Program -- Lender Oversight (Material Weakness)	Education has issued improved audit guidance to help ensure the reasonableness of lender billings to Education; however, a system to ensure that the lender audits are performed has not yet been implemented. These billings total $2.8 billion in cash outflows and $1.1 billion in cash inflows annually.	17
Cash -- Timely Reconciliations (Material Weakness)	Education needs to develop a better process of reconciling its cash balances and activity with Treasury. An unexplained difference of $183 million, more than Treasury, existed as of September 30, 1995.	21

Issue Area	Summary of Control Issues	Page Ref.
Pell and Federal Work-Study Grants -- Institutional Audits (Reportable Condition)	Education does not have a system in place to ensure that the external audits required of postsecondary educational institutions are performed. These institutions receive $6.9 billion annually in Pell and Federal Work Study Grants. Education needs to timely follow-up on questioned costs and internal control weaknesses identified in external audit reports and through its own reviews of postsecondary institutions.	24
PAS/PMS Systems -- Disaster Recovery and Security Concerns (Reportable Condition)	PAS and PMS are Education's two key financial systems. Disaster recovery plans are lacking for these systems that would ensure that Education could quickly resume processing in the event of disaster at the primary data centers. Improved security over the PMS system is required. Software capable of improving security is available, and it should be implemented as soon as possible.	29

* * * * *

Our consideration of the internal control structure would not necessarily disclose all matters in the structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. We also noted certain other matters involving the internal control structure that we will report to the management of Education in a separate letter.

This report is intended for the information of the Office of the Inspector General, the management of the Department of Education, and Congress. However, this report is a matter of public record and its distribution is not limited.

Price Waterhouse LLP

Washington, D.C.
June 4, 1996

FEDERAL FAMILY EDUCATION LOAN PROGRAM

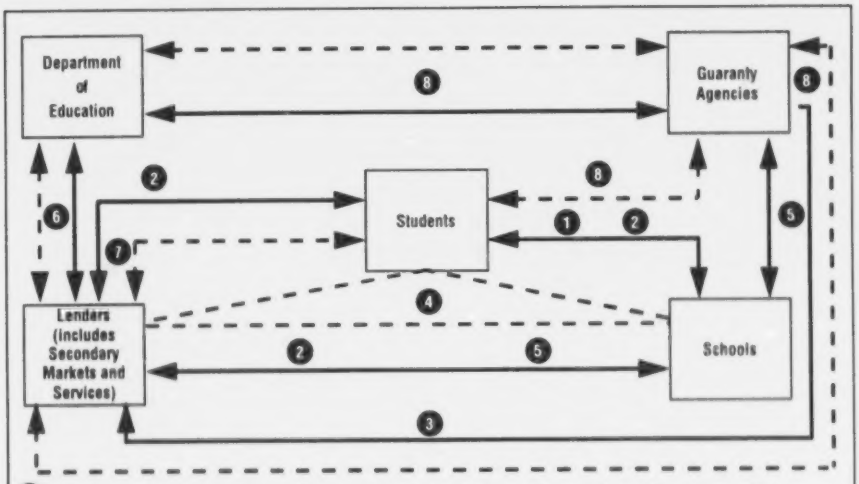
The Lack of Complete Loan Data in the FFEL Program Constrains Credit Management and the Department's Ability to Estimate a Liability for Loan Guarantees. ***(material weakness)***

Education has recorded a $12.9 billion liability for loan default losses and interest subsidies under its Federal Family Education Loan (FFEL) Program. Estimating and recording this liability is not only a critical step for preparing financial statements, but it should also be the outcome of a credit management process through which the Department assures individual loans are administered properly and cost effectively. The accuracy of the liability and effectiveness of the Department's oversight of the FFEL Program's credit management process ultimately depend upon the veracity of underlying data on individual guaranteed student loans. For example, historical data about the characteristics of the borrowers who defaulted, about how much of a claim payment was made and how much was subsequently recovered through collection efforts, are crucial to understanding why defaults occur and how to maximize recoveries. Analysis and use of this data for management purposes is particularly important when, as with the Department's FFEL Program, the administration of credit and collection of defaulted loans is in the hands of a variety of third-party intermediaries. We noted, however, that despite recent efforts to clean-up FFEL Program loan data, there are still many instances where key historical data is either missing or where questionable data cannot be explained. Further, these data problems could also affect the allowance for loss on direct loans, since historical data on guaranteed loans is the primary basis for calculating the direct loan allowance.

As shown in Figure 1 on page 7, many FFEL Program operations are performed by Lending Institutions and Guaranty Agencies (GAs). Key data necessary to calculate Education's liability estimate flows from approximately 8,000 lending institutions to 41 GAs and then to Education. Since inception of the FFEL Program audits for fiscal year 1992, the GAO and OIG have reported that based on their testing of loan documentation, significant errors existed in the data transmitted to Education such that Education cannot be assured that its liability estimate is materially correct. Our testing also revealed errors or missing data in the database used to calculate the liability.

Financial services institutions subject to Federal Regulatory oversight are required to maintain accurate loan and accounting data and have a process in place to analyze and evaluate such data to ensure proper credit management techniques are applied.

Figure 1: Federal Family Education Loan Program



1. Student provides school with financial information and school determines loan eligibility and counsels student.
2. Student generally obtains loan application from lender, fills out his or her portion, and forwards it to school; school completes application and forwards it to lender.
3. Lender provides information to guaranty agency; agency verifies student eligibility and agrees to guarantee loan; lender sends promissory note to student; student returns signed not to lender.
4. Lender issues check to be endorsed by both school and student.
5. School periodically confirms borrower's continued student status.
6. Lender bills the Department of Education for interests subsidy, reports loan origination fees collected, and provides summary information on its guaranteed loan portfolio.
7. Lender bills student when repayment starts, collects payments, and conducts statutory loan collection services if borrower becomes delinquent or in default.
8. Guaranty agency reimburses lender for defaulted loans, receives reinsurance and an administrative costs allowance from the Department. The agency also receives an insurance premium from students. The agency pays the Department a loan reinsurance fee, shares collections on defaulted loans, and provides the Department with summary information of loans it guaranteed.

Reprinted from GAO Report: GAO/AIMD 94-131

The absence of complete and accurate data causes regulators and auditors to question not only whether the institution is being operated in a "safe and sound" manner, but also the accuracy of related loss reserves. Under generally accepted accounting principles, data underlying loss reserves must be reliable and sufficient to explain, among other things:

- Deviations from historical patterns.
- Levels and trends in delinquencies.
- Differences in trends among intermediaries.
- Trends in recoveries.
- Sensitivity to variation.

Education recently engaged a contractor to develop a model for estimating the liability for FFEL Program loan guarantees and to develop the estimate as of September 30, 1995 for inclusion in Education's fiscal year 1995 financial statements. Data used by the contractor in calculating Education's FFEL Program liability estimate for fiscal year 1995 were derived from the sources as shown in Exhibit 2:

Exhibit 2:

Key data Components	Source	Data Availability
Defaults	NSLDS[1]	FY 1990 to present
Collections	NSLDS	FY 1990 to present
Outstanding Balance	NSLDS	January 1996 to present
Net Guarantees	Databook	FY 1965 to present

With the exception of net guarantees, only limited historical data was available to estimate the liability. Having accurate historical data about when and in what amount common groups (or cohorts) of loans default, repay or receive subsidies is important to understanding and managing credit risk as well as for calculating accurate loss reserves for financial statement purposes. Such information is also essential for assuring that

[1] National Student Loan Data System

credit reform subsidy calculations are as accurate as possible. Because of the data constraints, the contractor, in developing the fiscal year 1995 liability estimate, applied two general assumptions: 1) that available data can be used as a basis for constructing a historical performance pattern; for example, collection data from 1990 and forward can be used to construct prior year collection patterns; and 2) that any data errors, either previously identified or going forward, will essentially "net out" (i.e., they are unbiased) and thus will not have a material effect on the liability estimate.

Despite the efforts of the contractor, we do not believe the uncertainties created by the lack of and reliability of data have been overcome. In particular, there is no pre-1990 information available in the database. Education is still in the process of fully populating NSLDS with 1990 and later loan transaction data. Guaranty agencies were not required to report collections on defaulted loans for the entire six-year period from 1990 to 1995. However, some collection information was reported to the NSLDS at the guaranty agencies discretion. This means that Education had only six full years of actual collection data to use as a basis for projecting collections over the life of the loan. However, the majority of collections occur after year six of the loan. As such, there was very little data on which to assess historical collection patterns, and the contractor had to estimate the relationship between collections and defaults. This estimate was primarily based upon estimated defaults and estimated collections rather than actual defaults and actual collection data. Because collections are such a critical and material part of the liability calculation, this is simply not enough data to conclude that the liability could not vary materially.

With respect to the potential effect of data errors, in developing the FY 1995 model, the contractor reviewed the GAO and OIG identified errors from FY 1992 (a 34% error rate) and concluded that when netted together, the errors did not cause a "bias" in the assumptions underlying the liability estimate and thus did not have a material dollar impact on the overall liability. Implicit in this assumption is that the type of errors discovered by GAO and OIG and the data fields they affect would hold true for subsequent years as well. But there was no testing performed on post 1992 data to determine if this was in fact the case. The use of this assumption without corroborating information creates uncertainties about the liability estimate. This is particularly true when the potential effect of these errors is considered along with the uncertainties introduced by the lack of other important data.

Education's approach for the FFEL liability estimate for fiscal year 1995 also did not include adequate analysis of the underlying variables that explained trends, such as changes in default behavior or collection patterns due to the limitations of the available data. We were concerned that trends that existed in data produced by the model could

not be explained, other than anecdotally. For example, the model shows that default rates have dropped significantly for all school types. These trends could be due to an improved program, increased oversight of institutions, changes in the economy, unreliable data, or some other cause. We were not provided with empirical support that explained these trends in the data.

Recommendations

We recommend that:

1. Education must assure that NSLDS is populated with complete and accurate data. Anomalies must be quickly identified and missing data fields must be identified and resolved. These improvements could be accomplished through a combination of automated edit checks that would flag data fields with missing or unusual data, and verification of data transmission by the GAs' auditors.

2. For historical data Education should:

   - Select a statistically valid sample of the data population from the GAs' databases. The mature GAs' databases include additional years of loan experience not yet in the newer NSLDS.

   - Trace the sample drawn from the GAs' databases back to source documentation. This will provide a clean, tested sample that can be used to calculate the liability until NSLDS is more fully populated. Tests should be focused on data elements used (or planned for use) in the liability model.

   - Compare the verified sample data to the NSLDS database to evaluate the reliability of the NSLDS database. To the extent that inaccuracies are identified in the NSLDS database, this information will help target where corrective actions are necessary to improve NSLDS data reliability.

   - Use the data sample from the GAs' databases to calculate the liability until NSLDS is sufficiently populated with reliable data such that it can be used to calculate the liability.

- Consider the extent to which work being conducted by a contractor and work recently completed by the OIG can be used to help implement the individual points under this recommendation.

Education Needs to Complete Steps Underway for Improving Oversight of Guaranty Agencies. ***(material weakness)***

Guaranty Agencies (GAs) play a critical role in carrying out FFEL Program operations. There are approximately 41 GAs participating in the program. These State and not-for-profit institutions are responsible for reviewing student applications and approving loans, reviewing and paying claims to lenders when defaults occur, and for collecting on defaulted loans. Depending on their claims experience and the year the loan originated, GAs are reimbursed by Education for up to 100% (98% for loans disbursed on or after October 1, 1993) of claims they pay to lenders. At Education's discretion, GAs are also reimbursed for administrative expenses incurred in carrying out FFEL Program operations (equal to 1% of the new loan volume). GAs are required to remit to Education up to 73% of amounts collected on defaulted loans. They are permitted to retain the remaining portion of collected amounts to cover expenses associated with collection. But the amounts not remitted to Education and not used for collection and other allowable expenses are required to be held in a reserve account, known as the "Guaranty Reserve," an account which, by statute, is considered an asset of the Department.

Because the GAs are crucial intermediaries in delivering guaranteed loans to students, and because their financial and credit management activities so closely interact with those of Education, it is important that sufficient internal controls be in place to monitor their operations and properly account for transactions and assets executed or held on Education's behalf. However, we found instances where internal controls need to be strengthened, or where Education needs to complete action plans it has already initiated to address internal control weaknesses.

Additional Controls over GA Billings are Needed

GAs submit monthly billings (Form No. 1189) to Education for reimbursement of amounts paid for claims and administrative expenses, net of collections on defaulted loans. Aggregate GA billings to Education were as follows for fiscal year 1995.

Exhibit 3: GA Billings

GA Billings to Education for FY 1995 (in thousands)	
Reimbursements on defaults paid	$2,521,173
Mandatory administrative expenses	$257,862
Less collections on defaulted loans	($1,058,801)*
Net payments to GAs	$1,720,234

* The difference between this amount and collections reported in Education's financial statements ($2,013,058) is the exclusion of collections from ED's Debt Collection Service and from IRS offsets.

While Education can review GA billings for obvious errors or significant fluctuations, its automated systems are incapable of independently checking detailed supporting information for the billings. Instead, to a large degree, Education relies upon audits of GAs performed by private Independent Public Accountants (IPA) and State Auditors (auditors) to ensure the integrity of billings from GAs. The General Accounting Office (GAO) and Education's Office of Inspector General (OIG), in conjunction with their financial statement audits of the FFEL Program for fiscal years 1992 - 1994, reviewed the extent of the auditors' coverage of the GAs billings to Education. The GAO and OIG reported (GAO/AIMD-94-131) that based on interviews with the auditors and review of their working papers, that the "... auditors conducted only limited tests of the accuracy of the billings reports of the guaranty agencies." The GAO and OIG reported this condition as a material weakness for fiscal years 1992 - 1994. Based upon work performed during our 1995 audit, this condition has not yet been resolved.

It appears as though IPAs and auditors did not focus their testing on GA billings to the degree Education desires. Even though OMB guidance indicated that billing information should be tested, we believe the requirements were not specific enough with respect to the level of desired testing. Recognizing this, Education is developing improved audit guidance to be distributed to the auditors of the GAs that would specifically require testing of GA billings to Education. Education has substantially completed development of the new audit guide; however, it has not yet been issued.

Until the guidance is issued and implemented, we continue to report this condition as a material weakness for fiscal year 1995.

Commencing in late fiscal year 1995, Education performed on-site operational and financial reviews of GAs, that included limited testing of GA billings to Education. These reviews, which had not been conducted in prior years, were initiated as an additional control over guaranty agency operations. However, the workpapers documenting the results of the testing performed and conclusions reached are still in process. Thus, we do not know the extent to which the propriety of GA billings to Education was considered during these reviews or whether the reviews provided any assurance about their accuracy.

Receivables for Defaulted Loans Must Reconcile to GA Records

When students default on loans, lenders submit claims and are reimbursed by the GAs. When Education subsequently reimburses GAs, in most cases for almost the full amount of the claims paid, Education records an asset in its financial records to reflect the money it is now owed by the students who defaulted. On Education's behalf, GAs initiate collection efforts on the defaulted loans and are required to remit up to 73% of any amounts collected to Education. In effect, GAs are performing a loan servicing function for Education. But despite what organization performs the servicing, defaulted loans are an asset of the Department and controls must be in place to ensure the amounts owed and collections recovered are accurately reflected in Education's accounting records.

At the time of our audit, Education had $12.3 billion in gross loans receivable recorded on its general ledger related to defaulted loans for which the GAs were applying collection procedures. However, on the monthly status reports submitted by GAs (ED Form 1130), the loans reported by the 41 GAs aggregated $11.4 billion. A difference of approximately $888 million existed that cannot be explained other than anecdotally. (Education believes that the difference arose during periods prior to FY 1992 due to incorrect transaction tables for collections, contained in its general ledger system.) Education did adjust its general ledger balance to agree to the guaranty agency records, however, in the absence of sufficient information to ascertain whether the $888 million difference constitutes money Education is owed, or whether it simply represents errors or lags in reporting data to Education, we cannot be assured that the gross loan receivable balance is reasonably stated.

Accountability Over Reserves Maintained by GAs would be Improved if Accrual-Basis Information were also Required

Education provided the initial funding to establish the GAs and is the principal source of ongoing GA funding. Generally, assets accumulated by the GAs in carrying out their duties for Education that are not required to be immediately remitted, are retained by the GAs in a reserve account. But even though Education does not hold these reserves, they are still considered assets of the Department. The Higher Education Act (Sec. 422 (g) (1)) states:

> "Notwithstanding any other provision of law, the reserve funds of the guaranty agencies, and any assets purchased with such reserve funds, regardless of who holds or controls the reserves or assets, shall be considered to be the property of the United States..."

The Higher Education Act also specifies conditions under which the Secretary can require the GAs to return these funds. These conditions have been exercised in the past whereupon the Secretary has required return to the Federal government all or a portion of GA reserve funds. Information furnished by GAs indicated that reserves they held approximated $1.8 billion as of September 30, 1995 ($1.6 billion net of an allowance for loss). However, these reserves are reported to Education, as defined by 34 CFR Chapter VI Section 682 using the cash instead of accrual basis of accounting. We believe controls over GA reserves would be strengthened if the Department mandated that accrual accounting be used for purposes of reporting reserve balances to Education.

Education is Implementing Many Needed Improvements

Education recognized the need to improve GA oversight before our audit commenced. Many corrective actions are underway to address the conditions herein reported. In addition to drafting expanded guidance to be used by the external auditors that perform the audits of the GAs, Education is also in the process of implementing its National Student Loan Data System (NSLDS). The NSLDS will track all activity and balances for individual loans. Once implemented and completely populated with data, this system can be used for determining the reasonableness of billings from GAs and to better control Education's assets (i.e., loans receivable and reserves) held by the GAs. While portions of NSLDS have already been implemented, Education does not anticipate being able to use the system to determine the reasonableness of GA billings until fiscal year 1997.

Recommendations

We recommend that Education:

1. Establish an internal process for reviewing IPA reports and for documenting how matters or errors reported will be addressed and resolved.

2. Aggressively move forward with the issuance of its expanded guidance to IPAs and other auditors. This guidance should:

   - Specify that GA billings could have a direct and material effect on Education's financial statements and, as a consequence, should be sufficiently tested.

   - Require IPAs to review reconciliations between GA records and information submitted to Education (e.g. defaults, collections, guaranty amounts, etc.)

3. To the extent internally initiated reviews of GAs covered billings, summarize the amount and nature of errors noted and use this information as the basis for targeting internal and external testing to areas that are susceptible to error or abuse.

4. By individual GA, isolate differences between loans receivable reported by GAs versus those reflected in Education's records. Investigate any differences greater than 5%. Institute a process going forward in which claims paid and collections received by Education are reconciled to the loans receivable balance.

5 Consider mandating accrual accounting for purpose of reporting guaranty reserves to Education.

6 Assure that information produced by the new NSLDS accommodates the billing analysis discussed above.

Education Needs to Complete Steps Underway to Improve Oversight of Lenders in the FFEL Program. ***(material weakness)***

Under the FFEL Program, lending institutions (lenders) are another key component of the guaranteed loan system. These institutions provide loans to students. Guaranteed student loans are originated by approximately 8,000 lenders. From a financial point of view, the interaction between Education and lenders is critical with respect to fees and billings that pass between them. Lenders remit a loan origination fee of 3% of the loan balance to Education. In turn, lenders bill Education for interest subsidies to which certain students are entitled and for special allowances, which represent the differential between the maximum interest rate charged to students and the market interest rate at the time the loans were originated. Given the magnitude of the financial transactions between Education and lenders, an important control objective is to assure that fees and billings are properly calculated, are properly supported and are for the purposes authorized by Education. During fiscal year 1995, lenders submitted billings on ED Form 799 and remitted loan origination fees to Education as summarized in Exhibit 4.

Exhibit 4: Lender Billings

FY 1995 Lender Billings and Remittances to Education (in thousands)	
Interest Subsidy Billings	$2,185,647
Special Allowance Billings	$615,496
Origination Fee Remittances	($1,065,732)
Net Billings	$1,735,411

Having so many parties involved with the guaranty process adds complexities to the internal control structure. Automated information must be shared by disparate systems not designed for this purpose; thousands of individual audits must be conducted and their results carefully assessed; and financial transactions between the organizations must remain in sync and reconcilable. Oversight in this kind of environment is inherently convoluted and resource intensive. The internal control issues we identified are at least partly attributable to the difficulties of the environment.

Improving Control over Lender Billings is Still Needed

Education can review lender billings and fee remittances for obvious errors or significant fluctuations, but its automated systems are incapable of independently checking against detailed supporting information. Education's principal control for monitoring the integrity of lender billings is its requirement that lenders undergo audits by external auditors. However, the GAO and OIG in conjunction with their fiscal years 1992 - 1994 audits of the FFEL Program reported (GAO/AIMD-94-131) that:

> "... the external audits were broad in scope and auditors were not required to, and therefore did not conduct, in-depth examinations of the accuracy and validity of ... lenders' claims for defaulted loans, interest subsidies, and special allowances."

While Education has implemented certain corrective actions to address this issue, as discussed below, Education's actions have not been fully implemented. Therefore, the need for improved lender oversight still exists as of the end of our audit.

Education is in the Process of Implementing New Controls

In March of 1995, Education's OIG issued a new audit guide, entitled *Compliance Audits of the FFEL Program at Participating Lenders*. This new guide requires that the lender auditors specifically audit and report on the integrity of the billings to Education. While this new guide should significantly improve Education's assurance as to the propriety of lender billings, a number of open issues still existed in its implementation.

- A tracking system for lender audits is not yet in place. Education does not have a system in place to track the timely and complete submission of lender audit reports. Tracking and following-up on missing lender audit reports is important to assure all potential errors and issues are identified, and to maintain discipline over the lender audit process. Education also does not have a system in place to review lender audit reports that are submitted and to ensure appropriate follow-up of questionable charges and control issues identified by the auditors. This follow-up is important to ensure that Education is reimbursed for amounts improperly billed by lenders and to ensure lenders stop inappropriate billing practices. We understand that Education is in the process of developing an automated system to perform these critical functions; however, implementation is not scheduled until later this summer.

- Not-for-profit and government entities are not specifically required to follow the new audit guidance. Information provided by professional bodies might encourage auditors to follow agency guidance that would appear applicable, if not specifically required. However, since Education "recommends" rather then requires following its new guidance, it is possible that this could be misinterpreted. Not-for-profit and Government entities service approximately 50% of the total loan portfolio. Some Government and not-for-profit entities are already voluntarily applying the new audit guide; however, the extent of voluntary compliance is unknown.

- GAs are not required to follow the new audit guidance for the lender program reviews they conduct. GAs are required to perform reviews of the ten largest lenders for which they guarantee loans. However, Education's guide for the GAs for performing these reviews is outdated (issued 1989) and provides very limited guidance about how and to what degree GAs should test lender billings to Education. The outdated GA guide does not include the more comprehensive review steps found in the updated lender audit guide.

In addition to improving its audit guidance for oversight of lenders, Education is in the process of implementing its NSLDS and populating this system with data. NSLDS will track loan activity and balances at a detail level, including identification of loans held by each lender. Once implemented and populated, Education plans to use this system to determine the reasonableness of billings from lenders by comparing the loan detail contained in the system to lender billings. While portions of this system have already been implemented, Education does not anticipate being able to use this system to determine the reasonableness of lender billings until fiscal year 1997.

Recommendations

We recommend that Education:

1. Identify missing/delinquent lender audit reports and follow-up with lenders to obtain the reports. One option for identifying missing reports is to compare the lender payments database to the lender audit reporting database.

2. Summarize lender audit reports that identify questioned costs or improper billing practices. Assess the reasons errors occurred and their financial effect; systematically pursue reimbursement where questioned costs are identified.

3. Based on the summarized results of the lender audits, modify audit guidance to concentrate on areas identified as vulnerable.

4. Determine which government and not-for-profit entities are not following audit guidance recommended by Education, and place more emphasis on these entities as part of Education's program reviews.

5. Consider updating the GAs audit guidance to be more specific and compliment the work already being performed by IPAs under the new lender audit guide.

6. Complete and implement the system being developed to track receipt of lender audit reports.

EDUCATION'S FINANCIAL SYSTEMS

Education is Unable to Fully Reconcile its Cash Balances with Treasury. (*material weakness*)

A major objective of our financial audit is to assess the effectiveness of internal controls that ensure the integrity of the underlying accounting data that are included in Education's financial statements. An important control in this regard is the periodic reconciliation of Education's accounting records with records maintained by the Department of Treasury, which effectively serves as Education's bank. Proper reconciliations provide assurance that all disbursements, receipts and appropriated funds transactions that are processed on Education's behalf by Treasury are recorded in Education's accounting records. Remaining in-balance or reconcilable with ones bank account is perhaps the most fundamental and important control for assuring the accounting records remain consistent with cash transactions. Thus quarterly reconciliations, followed by prompt action to resolve differences, are necessary to ensure the reliability of accounting data and management control over cash transactions.

For many years, Education has been working to identify, explain and resolve differences between its accounting records and cash transactions reported by Treasury. It has made significant progress. During fiscal years 1993 and 1994, Education undertook an extensive reconciliation project that resulted in a need to post over 500 adjustments, aggregating billions of dollars ($889 million, net), to adjust its cash balances as recorded in its general ledger to agree with Treasury.

However, despite these efforts, unreconciled differences continue to occur and our work showed that these differences cannot be wholly attributed to old transactions that persistently cause such differences. Since the earlier reconciliation effort was completed, an additional unreconciled difference of $183 million, more than Treasury, has accumulated.

There is no documentary evidence that would explain what this $183 million difference consists of and what effect it might have on the financial statements, if some or all of it were found to contain errors. Even though the remaining unreconciled balance is relatively small when compared to Educations $39 billion Treasury balance, we have reported it as a material weakness. We have done so because of the importance this particular control has on the integrity of the internal control structure, because

persistent differences appear to arise as a result of systemic problems, and because there is a lack of evidence that can conclusively show that this difference is inconsequential.

Education attributes its reconciliation problems to inadequate integration between its general ledger system and its payments and funds control systems that are the original points of entry for many cash transactions. These integration problems result in certain cash transactions not being properly and timely transferred from the originating systems to Education's general ledger system, thus causing Education's cash balances as recorded in its general ledger to differ with Treasury. Moreover, Education's general ledger system is not well integrated with external systems Education uses to process its payroll and administrative disbursements; systems that interface directly with Treasury.

To correct its financial systems problems, Education is implementing the Education Central Automated Processing System (EDCAPS). EDCAPS will improve integration between Education's general ledger and other financial systems and thus reduce the problems in posting of transactions to the general ledger that currently exists. Improved data posting to Education's general ledger should reduce differences that exist between Education's cash balances as recorded in its general ledger and Treasury balances, and to research the differences that do exist. As long as Education concurrently develops a process through which the new system is used to thoroughly and regularly reconcile with Treasury, the reconciliation problem should be solved on a going forward basis. EDCAPS is scheduled to be implemented in late 1997.

For unreconciled differences that accumulate before EDCAPS is implemented, Education is developing automated programs to facilitate identification of differences in data between its general ledger system and its payments and funds control system, which is necessary to identify the causes of differences with Treasury. These automated programs are being developed for Education's 55 largest appropriations, which account for approximately 95% of Education's cash activity. If these programs are able to disaggregate unreconciled differences into categories such that timing differences, posting problems or errors can be identified, then pre-EDCAPS differences can also be resolved.

Recommendations

We recommend that Education:

1. Develop and document a quarterly process to perform reconciliations that identify specific differences between detailed records supporting its general ledger balances and those supporting Treasury's records. This process should take into account information that can be provided once EDCAPS is implemented.

2. Investigate and document the causes of the differences, e.g., whether the differences are caused by timing of posting of information (between its general ledger and Treasury's records), missing transactions, or errors in posting transactions.

3. Require that any future adjustments to its cash records be documented and that such documentation be maintained for review and audit purposes.

PELL GRANT PROGRAM

Oversight and Analysis of Audits of Postsecondary Educational Institutions Needs Improvement. ***(reportable condition)***

The Higher Education Act of 1965, as amended, authorizes Education to provide grants to assist financially disadvantaged students in obtaining quality postsecondary education. The largest grant programs are the $6.3 billion Federal Pell Grant program and the $616 million Federal Work Study Programs. Grants are provided to approximately 4 million students. The amount of the grant for which the student is eligible is based on his/her family income and the institutions' tuition. The institution guides the student in completing the grant application and processes the application through Education's central processing facility. The institution is also responsible for confirming income data reported by the students on a sample basis.

Although the grants are made for the benefit of the students, they are paid directly to the institutions which apply them primarily against the students' tuition. Approximately 7,900 institutions received grant funds. Approximately 2,600 of these institutions are proprietary (for-profit) institutions, the balance are government and not-for-profit institutions. In testing grant expenditures, our financial audit focused on Education's control structure for ensuring that funds provided to the institutions were for eligible students at allowed amounts. Education's control structure over the institutions includes the following:

- Institutions are required to submit applications and meet statutory eligibility and certification requirements for participation in Education's programs.
- All participating institutions must have independent financial and compliance audits performed annually.
- On-site reviews of a sample of institutions each year conducted by Education personnel.
- Students applying for grant assistance must submit applications to Education's central processing site. At this central processing site Education performs some student eligibility checks and computes factors that are later used to determine

eligible grant amounts (based on data reported in the application by the students).

Results of External Audits Need to be Summarized and Followed-up

Education's principal control for ensuring that grant funds are being spent for eligible students at allowed amounts is its requirement that all participating institutions have routine financial and compliance audits performed by Independent Public Accountants or State Auditors (auditors). These audits are required by the Single Audit Act for government entities, by OMB Circular A-133 for not-for-profit institutions and by the Higher Education Act for proprietary institutions. Education has issued guidance for the auditors performing these audits which requires testing of controls and transactions related to the grant funds obtained by these institutions. However, during our audit of Education's processes for overseeing the institutional audits we found that:

- There is inadequate assurance that all postsecondary institution audit reports are received. Education maintains two systems for audit report tracking and resolution; however, neither system had been used to identify late or missing reports. Thus, Education could not be assured that all audits of the institutions are being performed.

- More timely resolution of audits of postsecondary institutions is required. When problems are noted in the audit reports that are received, Education follows-up with the institutions to work out an agreed upon course of corrective action, which in some cases requires repayment of funds improperly used by the institutions. Education's policy, as well as the requirements of OMB Circular A-50, is to require a response to problems identified in the audit reports within six months of receipt of the reports. In the sample we selected for testing, we found that approximately a quarter of the audit reports that identified problems were not resolved with the institutions within six months of receipt.

- Extent of misspending is not quantified. Education does not have processes in place to periodically estimate the extent of misspending that is occurring in its postsecondary grant programs. This information is necessary for Education to assess whether grant expenditure amounts included in its financial statements are fairly presented in accordance with laws and regulations governing these programs. This information is also needed to assess whether a cost-effective control structure is in place to ensure that funds are expended for eligible students at allowed amounts.

Education has initiated efforts to identify missing postsecondary institution audit reports and analyze their findings. However, this process was not complete by the time our field work ended.

Effectiveness of On-site Monitoring Reviews Should Also be Improved

Education's regional offices perform on-site reviews of postsecondary institutions to provide technical assistance and determine compliance with program regulations, including appropriate use of grant funds. OPE states approximately 860 institutions (out of a population of 7,885) were reviewed during fiscal year 1995. During our audit we noted the following with regard to these reviews:

- Improved risk analysis is required in selecting institutions for review. The Office of Postsecondary Education (OPE) has identified 25 risk factors to aid the field offices in identifying higher risk institutions on which to focus their limited monitoring resources. These 25 risk factors, however, resulted in identification of the majority (95%) of institutions as in need of review. There was no further weighing or ranking of the risk factors to identify the highest risk institutions for review. Thus, the risk factors as presently constituted are not effective as a means of targeting limited resources. We understand that OPE has assembled a team to further refine the risk assessment process to better target its limited monitoring resources towards the highest risk institutions.

- Reviews are not resolved timely. Education's policy requires issuance of the monitoring report within 30 days of the on-site monitoring of the institutions. In the sample we selected for testing, we found that approximately half of the reports were not issued within this timeframe. About 10% of the reports had not been issued within 120 days after completion of the reviews.

Redundancies Exist in Audit Tracking Systems

Education currently maintains two systems for audit tracking and resolution. The Common Audit Resolution System (CARS) maintained by the Office of the Chief Financial Officer is used to track audit reports for all recipients of Education funds. The Institutional Data System (IDS) maintained by the Office of Postsecondary Education (OPE) is used to track receipt of audit reports for institutions receiving postsecondary funds. While these two systems collect information unique to each office, they also contain a substantial amount of similar information. Data interfaces have been developed that generally reduce duplicate data entry, but it is still inefficient

to develop and maintain systems that contain many redundancies to achieve similar objectives.

Recommendations

We recommend that Education:

1. Complete the process of identifying missing/delinquent reports with regard to the external audits of postsecondary educational institutions and following-up with institutions to obtain the reports. One option for identifying participating institutions that have not submitted audit reports is to compare the payments database (Central Registry System) to the audit reports database.

2. Timely follow-up with institutions where audit reports identify questioned costs or material control weaknesses. For these institutions, Education should quantify the extent of any misspending and seek reimbursement of misspent funds.

3. Continue to perform periodic quality control reviews of the audits to ensure that the audits are addressing areas of risk to Education.

4. Quantify the extent of missing reports and questioned/sustained costs to assess materiality on the department's financial statements.

5. Complete development of a risk-based strategy for determining how to most effectively deploy limited institution monitoring resources. This monitoring strategy should be coordinated with audit coverage provided through the external audits already required of the institutions. For example, Education should consider focusing a portion of its monitoring resources on institutions where the external audits disclose problems or on those institutions that do not timely submit audit reports. Conversely, where the external auditors do not disclose financial and compliance issues, Education's reviews might focus some attention on areas not already covered by the independent auditors (i.e., program delivery issues).

6. Consider maintaining a single automated system to track reports stemming from audits of government, not-for-profit, and proprietary educational institutions. Additionally, Education should determine if the external audit reports received from lenders could also be tracked in this same system, thus resulting in maintenance of a single audit tracking and resolution system for the entire Department.

CONTROLS OVER AUTOMATED SYSTEMS

Improvements are Required in Security over Financial Systems and in Disaster Recovery Capabilities. ***(reportable condition)***

In performing our audit, we tested system security and disaster recovery capabilities for Education's key financial systems. Education's Primary Accounting System (PAS) is the general accounting system for the Department. Another key financial system is the Payment Management System (PMS), which is used to process approximately $28 billion in grant and contract disbursements annually. Funds are disbursed through PMS to government and private institutions.

During our audit testing, we identified system security problems within the PMS system. Specifically, we found a mainframe-based security package (Resource Access Control Facility -- RACF) which would provide the necessary security for PMS is available to Education. RACF provides many features to limit access such as password controls, transaction controls, and logging/reporting functionality. If properly implemented, the RACF security software will greatly reduce the risk of unauthorized access to PMS and provide increased assurance as to the integrity of Education's disbursement data. Education is currently analyzing the cost feasibility of implementing RACF.

Because the security package has not been implemented, Education must rely upon application level security that is built into the PMS system. The application level security does not provide a sufficient level of security for PMS, particularly given this system's role in controlling disbursements of over $28 billion annually. The deficiencies in PMS security could enable unauthorized users to access confidential data, change data, make unauthorized payments, or bring down the system. Details as to specific security vulnerabilities that exist in PMS are being reported to Education's management under separate confidential cover.

We also identified deficiencies in disaster recovery capabilities for both PAS and PMS. Although a high level framework for disaster recovery exists, a formal, detailed plan has not been established, approved and tested. The absence of a formal, tested data recovery plan means that Education may not be able to recover critical systems and data and resume processing in the event of a disaster at one of its principal data centers.

Education has already begun to respond to this concern raised during our audit. A statement of work has been drafted to obtain contractor assistance in developing a disaster recovery plan for PAS. With regard to PMS, Education has begun to work with the existing contractor that operates this system to develop a disaster recovery plan. We note that these plans must not only address how to recover from the occurrence of a disaster, but also how to continue to support critical functions during the recovery stage.

Recommendations

We recommend that Education:

1. Implement the RACF security package as soon as possible.

2. Prepare a formal disaster recovery plan for the PAS and PMS systems that:

   - Identifies critical applications and their recovery and telecommunication requirements.
   - Determine the site and capacity need for a back-up center.
   - Document recovery/ activation procedures.

3. Periodically test the disaster recovery plan once it is implemented.

Financial Statements and Accompanying Notes

UNITED STATES DEPARTMENT OF EDUCATION

CONSOLIDATED STATEMENT OF FINANCIAL POSITION
September 30, 1995
(DOLLARS IN THOUSANDS)

ASSETS	
Entity Assets	
Intragovernmental Assets:	
Fund Balances with U. S. Treasury	$39,375,252
Governmental Assets:	
Credit Program Receivable, Net:	
Defaulted Guaranteed Loans	3,203,028
Direct Loans	3,139,881
Facilities Loans	533,086
Advances to Guaranty Agencies, Net	39,763
Accounts Receivable, Net	5,484
Advances and Prepayments	74,587
Investments	19,148
Total Entity Assets	46,390,229
Non-Entity Assets	
Governmental Assets:	
Guaranty Agencies' Reserves Receivable, Net	1,628,069
Other Receivables, Net	39,267
Total Non-Entity Assets	1,667,336
Total Assets	$48,057,565

The accompanying notes are an integral part of these statements.

UNITED STATES DEPARTMENT OF EDUCATION

CONSOLIDATED STATEMENT OF FINANCIAL POSITION
September 30, 1995
(DOLLARS IN THOUSANDS)

LIABILITIES AND NET POSITION	
Liabilities	
Liabilities Covered by Budgetary Resources	
Intragovernmental Liabilities:	
Borrowing from U. S. Treasury	$ 5,610,339
Interest Payable to U. S. Treasury	12,049
Governmental Liabilities:	
Liabilities for Loan Guarantees, Short-term	4,804,931
Liabilities for Loan Guarantees, Long-term	7,045,493
Guaranty Agencies' Reserves - Due to Treasury	1,628,069
Accrued Grant Liability	845,936
Accrued Contractual Services Liability	69,820
Accrued Salaries and Benefits	14,013
Other Accrued Liabilities	62,424
Total Liabilities Covered by Budgetary Resources	20,093,074
Liabilities Not Covered by Budgetary Resources	
Intragovernmental Liabilities:	
Borrowing from U.S. Treasury	1,134,178
Governmental Liabilities:	
Liabilities for Loan Guarantees, Long-term	1,056,039
Accrued Salaries and Benefits	20,198
Accrued Workers Compensation Liability	10,431
Total Liabilities Not Covered by Budgetary Resources	2,220,846
Total Liabilities	22,313,920
Net Position	
Unexpended Appropriations	27,881,683
Invested Capital	82,647
Future Funding Requirements	(2,220,846)
Donations	161
Total Net Position	25,743,645
Total Liabilities and Net Position	$48,057,565

The accompanying notes are an integral part of these statements.

UNITED STATES DEPARTMENT OF EDUCATION

CONSOLIDATED STATEMENT OF OPERATIONS AND CHANGES IN NET POSITION
For the Year Ended September 30, 1995
(DOLLARS IN THOUSANDS)

REVENUES AND EXPENSES	
Revenues	
Interest, Non-Federal	$ 82,931
Interest, Federal	847,844
Other Revenue	316
Total Revenues	931,091
Expenses	
Guaranteed Loan Subsidy Expense	2,651,988
Direct Loan Subsidy Expense	436,132
Elementary and Secondary Education Grants	9,324,757
Postsecondary Education Grants	8,149,761
Special Education and Rehabilitative Services Grants	5,580,045
Other Grants	2,035,320
Interest Expense	1,036,332
Salaries and Administrative Expenses	401,932
Contractual Program Expenses	667,261
Bad Debt and Write-offs	2,919
Other Expenses, Net	559
Total Expenses	30,287,006
Net Operating Activity	$(29,355,915)
CHANGES IN NET POSITION	
Net Position , Beginning of Year	$ 22,665,748
Net Operating Activity	(29,355,915)
Plus (Minus) Non-Operating Changes	
Appropriated Funds Received	33,274,634
Appropriated Funds Returned	(875,040)
Appropriations Transferred From Others	34,218
Net Position, End of Year	$ 25,743,645

The accompanying notes are an integral part of these statements.

UNITED STATES DEPARTMENT OF EDUCATION

CONSOLIDATED STATEMENT OF CASH FLOWS
For the Year Ended September 30, 1995
(DOLLARS IN THOUSANDS)

NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES	
Operating Cash Provided	
Default Claims Collected	$ 2,013,058
Loan Origination and Other Fees	1,146,894
Interest Income, Federal	804,695
Interest and Penalty Income, Non-Federal	51,808
Other Operating Cash Provided	295
Total Operating Cash Provided	4,016,750
Operating Cash Used	
Interest and Penalties, Non-Federal	(54)
Interest, Federal	(525,993)
Default Claim Payments	(2,521,173)
Interest Subsidy Payments	(2,185,647)
Special Allowance Payments	(615,496)
Mandatory Administrative Expenses	(257,862)
Grants, Advances, and Contributions	(25,014,693)
Salaries and Benefits	(308,682)
Rent, Communications, and Utilities	(53,444)
Contractual Program Services	(658,288)
Printing and Reproduction	(15,718)
Travel and Transportation	(11,954)
Materials, Supplies, and Equipment	(21,679)
Guaranty Agency Collection Fees	(285,376)
Other Operating Cash Used	(4,585)
Total Operating Cash Used	(32,480,644)
Net Operating Cash Used by Operating Activities	(28,463,894)

The accompanying notes are an integral part of these statements.

UNITED STATES DEPARTMENT OF EDUCATION

CONSOLIDATED STATEMENT OF CASH FLOWS
For the Year Ended September 30, 1995
(DOLLARS IN THOUSANDS)

CASH PROVIDED (USED) BY INVESTING ACTIVITIES	
Collection of Advances	750
Loan Repayments Received	73,847
Loan Disbursements	(3,267,940)
Net Cash Used by Investing Activities	(3,193,343)
CASH PROVIDED (USED) BY FINANCING ACTIVITIES	
Appropriated Funds Received	33,274,634
Appropriations Transferred From Others	34,218
Appropriated Funds Returned	(875,040)
Net Appropriations	32,433,812
Repayments to U.S. Treasury For Borrowings	(759,319)
Borrowing from U.S. Treasury	4,892,496
Net Cash Provided by Financing Activities	36,566,989
Net Cash Provided by Operating, Investing, and Financing Activities	4,909,752
Fund Balances with U. S. Treasury , Beginning of Year	34,465,500
Fund Balances with U. S. Treasury , End of Year	$39,375,252

The accompanying notes are an integral part of these statements.

UNITED STATES DEPARTMENT OF EDUCATION

CONSOLIDATED STATEMENT OF CASH FLOWS
For the Year Ended September 30, 1995
(DOLLARS IN THOUSANDS)

RECONCILIATION OF NET OPERATING ACTIVITY BEFORE APPROPRIATIONS TO NET CASH USED BY OPERATING ACTIVITY

Net Operating Activity	$(29,355,915)
Adjustments to Reconcile Net Operating Activity to Net Cash Used by Operating Activities:	
Allowance for Subsidy	507,069
Changes in:	
Decrease (Increase) in Credit Program Receivable, Net:	
Defaulted Guaranteed Loans	301,843
Direct Loans	(66,552)
Facilities Loans	(14,032)
Decrease in Advances to Guaranty Agencies, Net	1
Increase in Accounts Receivable, Net	(2,123)
Decrease in Advances and Prepayments	59,808
Increase in Other Receivables, Net	(39,267)
Increase in Interest Payable to U. S. Treasury	1,910
Increase in Liabilities for Loan Guarantees	81,529
Increase in Accrued Grant Liability	16,501
Increase in Accrued Contractual Services Liability	12,136
Decrease in Accrued Salaries and Benefits	(10,980)
Increase in Other Accrued Liabilities	42,799
Increase in Accrued Workers Compensation Liability	1,379
Net Adjustments	892,021
Net Cash Used By Operating Activities	$(28,463,894)

Supplemental Schedule of Noncash Investing Activities

School disbursements included in accounts payable	$(18,450)
Writeoff of Principal/Adjustments/Cancellations	(833)
Interest Capitalized to Principal	1,190
Total Supplemental Schedule of Noncash Investing Activities	$(18,093)

The accompanying notes are an integral part of these statements.

NOTE 1 - REPORTING ENTITY

These consolidated principal financial statements present the financial position and activity of the U.S. Department of Education (ED), a cabinet level agency of the Executive Branch of the United States Government. ED executes programs under the Education, Training, Employment and Social Services function established by Congress in the Budget Act of 1974. ED's financial activity relates to execution of its congressionally approved budget and programs. This activity is recorded in individual general (appropriated) funds and summarized by principal office for reporting purposes.

These statements include the activity and balances of the Federal Family Education Loan (FFEL) and William D. Ford Direct Loan programs, which were reported last year as separate program financial statements for the fiscal year ended September 30, 1994. The FFEL Program, authorized by the Higher Education Act of 1965, as amended (HEA), operates with state and private nonprofit guaranty agencies to provide loan guarantees and interest supplements through permanent budget authority on loans by private lenders to eligible students attending participating postsecondary schools. The Direct Loan Program, authorized by the Student Loan Reform Act of 1993, is an alternate to the FFEL Program in which loan capital is provided by the federal government through borrowing from the U.S. Treasury.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

These financial statements have been prepared to report the financial position, results of operations and changes in net position and cash flows of the Department, as required by the Chief Financial Officers Act of 1990 (Public Law 101-576). ED prepared the financial statements from its books and records in accordance with the Department's accounting policies, which are summarized in this note. These statements are different from the financial reports used to monitor and control the use of budgetary resources, which are also prepared by ED pursuant to OMB directives.

ED's accounting policies follow an "other comprehensive basis of accounting," comprising the following hierarchy, agreed to by the Comptroller General, the Secretary of the Treasury and the Director of the Office of Management and Budget (OMB):

1. Accounting principles, standards and requirements approved by the above named officials. These are known as Statements of Federal Financial Accounting Standards (SFFAS).

2. Form and content requirements in OMB Bulletin 94-01, Form and Content of Agency Financial Statements, dated November 16, 1993, and subsequent issuances.

3. Accounting standards contained in agency accounting policy, procedures manuals, and/or related guidance as of March 29, 1991, so long as they are prevalent practices.

4. Accounting principles published by authoritative standard setting bodies and other authoritative sources (1) in the absence of other guidance in the first three parts of this hierarchy, and (2) if the use of such accounting standards improves the meaningfulness of the financial statements.

OMB Bulletin 94-01 prescribes a framework for agencies to develop financial statements which provide information useful to Congress, government officials, and the public. OMB approved the following deviations from OMB Bulletin 94-01 in ED's Principal Statements:

The Statements of Operations and Changes in Net Position follows the format suggested in the Governmental Accounting Standards Board's Codification of Governmental Accounting and Financial Reporting Standards, which identifies a separate disclosure for the total effects of operations, exclusive of appropriations or intra-governmental funding sources.

We have replaced the two separate student loan program reporting entities with a single consolidated reporting entity for the entire Department of Education.

We have discontinued the Statement of Budgetary Resources and Actual Expenses, which is not provided for in the Government Management Reform Act of 1994 nor in the Statement of Federal Financial Accounting Concepts for Entity and Display, issued April 20, 1995 by OMB.

Basis of Accounting

Transactions are recorded on an accrual accounting basis. Therefore, revenues are recognized when earned and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash.

Basis of Consolidation

The accompanying consolidated financial statements include the accounts of all funds under ED's control. All interfund balances within ED have been eliminated. The consolidated financial statements do not include centrally administered assets and liabilities related to the federal government as a whole, such as General Services Administration owned property and equipment, and borrowing from the Public by the U.S. Treasury, which may in part be attributable to ED.

Budgets and Budgetary Accounting

The components of ED's budgetary resources include current budget authority (i.e., appropriations and borrowing authority) and unobligated balances remaining from multi-year and no-year budget authority received in prior years. Budget authority is the authorization provided by law to enter into financial obligations that result in immediate or future outlays of federal funds. Budgetary resources also include

reimbursements received and other income (i.e., spending authority from offsetting collections credited to an appropriation or fund account) and adjustments (i.e., recoveries of prior year obligations). Pursuant to Public Law 101-510, unobligated balances associated with appropriations that expire at the end of the fiscal year remain available for obligation adjustments, but not new obligations, until that account is canceled. When accounts are canceled, five years after they expire, amounts are not available for obligation or expenditure for any purpose.

Financing Sources and Program Revenues

ED receives the majority of the funding needed to support its programs through congressional appropriations. Borrowing from the Treasury, another financing source, provides most of the funds for the Direct Loan Program loans to students and Facilities Loan Program loans to postsecondary institutions. The effect on ED's net position of appropriations received, returned and transferred to others is shown in the Statement of Changes in Net Position.

Revenues are recognized as financing sources to the extent these receipts were payable to ED from other agencies and from the public in exchange for goods and services rendered to others. Major sources of reported revenues include interest accrued or collected from Direct Loan Program borrowers on outstanding loans receivable and interest accrued or collected from Treasury on uninvested fund balances. Fees received on student financial assistance loans, such as loan origination fees, are offset against subsidy costs and therefore are not reported as revenue.

Subsidy Estimates and Reestimates

The Federal Credit Reform Act of 1990 (CRA) was enacted to measure the costs of federal credit programs more accurately, place the cost of credit programs on a budgetary basis equivalent to other federal spending, encourage the delivery of benefits in the form most appropriate to the needs of the beneficiaries, and improve the allocation of resources among and between credit programs and other spending programs. All credit programs within ED conform with the provisions of CRA beginning with fiscal year 1992 transactions.

CRA, SFFAS No. 2 – Accounting for Direct Loans and Loan Guarantees, and related regulations and guidance, require recording the net present value of subsidy costs (i.e., estimated interest rate differentials from market rates, interest subsidies, defaults, collections on defaulted loans, fee offsets, certain administrative expenses, and other cash flows) associated with direct loans and loan guarantees to be recognized in the year loans are made for both budgetary and accounting purposes. In addition, the net present value of these subsidy costs are recorded as liabilities for loan guarantees.

Subsidies are estimated based on the difference between present values of expected government cash outflows and inflows, discounted by the interest rate earned by a Treasury debt instrument of similar

term on the date loans are made. Subsidy costs are recognized as expenses in the year loans are disbursed.

In accordance with SFFAS No. 2, the subsidy costs of credit program loans are reestimated each year as of the financial statement date. A reestimate is a change in the net present value of estimated cash flows due to changes in interest rates, defaults, delinquencies, prepayment and recoveries. Any increase (decrease) in the subsidy cost resulting from the reestimates is recognized as an increase (decrease) of subsidy expense.

Fund Balances With U.S. Treasury

ED does not maintain significant amounts of cash in commercial bank accounts. Cash receipts and disbursements are generally processed by the U.S. Treasury. However, ED has the authority to disburse U.S. Treasury funds directly to agencies and institutions participating in ED programs. The Fund Balances with U.S. Treasury are primarily revolving funds, other appropriated funds and undisbursed U.S. Treasury borrowings available to pay current and finance subsidy expenses for post-1991 loans. A portion of the appropriated funds included at September 30, 1995 were forward-funded by multi-year appropriations for expenditures anticipated during the year ending September 30, 1996. ED does not have any restricted unobligated balances. Fund Balances with U.S. Treasury do not include any non-entity funds.

Investment

Congress authorized the Department to invest in the College Construction Loan Insurance Association (commonly known as Connie Lee) start up costs when it was incorporated in 1987. Connie Lee was created to insure and re-insure the financing of construction of postsecondary educational facilities. ED has two appointed members on Connie Lee's Board of Directors and holds about 14 percent of its shareholder equity. While Connie Lee may be considered a government sponsored enterprise, it is neither a government corporation nor a government controlled corporation. Therefore, ED would not incur any liabilities if Connie Lee suffered losses or went bankrupt. This investment is reported at cost. However, the Secretary of Education is authorized to sell any portion, or all, of this investment at a price equal to the original cost of purchase or at a higher price based on an independent market appraisal. No independent appraisal has been developed under this authority. Therefore, no provision is made for unrealized gains or losses on this investment.

Seven of the 21 members of the Student Loan Marketing Association (Sallie Mae) Board of Directors are appointed by the President of the United States. However, neither ED nor the federal government has any investment in that for-profit corporation. ED's transactions with Sallie Mae are essentially the same as those with any other lender organization.

Grant Advances and Payables

Disbursements of funds under ED's more than 200 grant programs are generally made when requested by grantees. These drawdown requests are usually received and fulfilled before grantees make federal program expenditures. When funds have been disbursed by ED, but expenditures are not yet reported by grantee/recipients, these disbursements are reported as advances. However, if a recipient reports program expenditures that have not been advanced by ED as of September 30, 1995, such amounts are reported as grants payable and grant expenses.

Credit Program Receivables

Credit program receivables are carried at the principal amounts outstanding, net of allowances for subsidy or uncollectible receivables. Credit programs include the FFEL and Direct Loans programs, and the Facilities Loan Program. Allowances for subsidy cost represent the differences between the present values of net cash inflows and outflows of the underlying credit program loans. The cash flows include collections of principal and interest, prepayments, recoveries and fees, and disbursements of interest subsidies, special allowances and default claims. The allowance for subsidy is amortized by the effective interest method using the interest rate determined at the time credit program loans were disbursed. For the pre-CRA loans, the allowances for uncollectible receivables represents an analysis of loan collectibility based on risk groupings of borrowers.

Guaranty Agency Reserves

Federal fund balances held by the state and non-profit guaranty agencies participating in FFEL Program operations are recognized as ED receivables and as payables to Treasury as explained in Note 9. These balances are offset by an allowance for uncollectibles based on ED management's judgment.

Other Receivables

Other accounts receivable are due from recipients of grant and financial assistance programs, and other federal agencies. These amounts are initially listed and controlled in a claims-in-process file due to their contingent nature. When the collection probability of such a claim is established by obtaining a payment, promissory note, or entering into a settlement agreement with the debtor, an accounts receivable and offsetting historically determined allowance for uncollectibility is recorded in the ledgers and reported in the statements.

Liabilities

Liabilities represent the amount of monies or other resources that are likely to be paid by ED as a result of transactions or events that have already occurred. However, no liability can be paid by ED absent an appropriation or borrowing authority. Liabilities for which an appropriation has not been enacted

are therefore classified as liabilities not covered by budgetary resources (unfunded liabilities). Most of FFEL and Direct Loan program liabilities result from entitlements covered by permanent authority and ED is required to pay these liabilities if all eligibility requirements are met. Any non-entitlement liability of the Department, such as federal administrative costs, not arising from contracts, and entitlements not yet vested, can be abrogated by the government acting in its sovereign capacity.

Under the FFEL Program's accounting policies, liabilities for loan guarantees include provisions for payment of loan defaults, interest and special allowance benefits, certain administrative expenses (administrative expense allowances and supplemental preclaims assistance) and interest expense. These liabilities are offset by estimated future collections on loans that will default, loan origination fees paid by borrowers, and fees paid by lenders, including Sallie Mae.

Liabilities are recognized when applicable for funds expended by state and local governments and other recipient organizations for amounts due and payable by ED under the terms of financial assistance agreements.

Borrowing from the U.S. Treasury

Borrowings from the U.S. Treasury provide most of the funding for loans in the Direct Loan and Facilities Loan programs. Principal repayments are made to Treasury based on the repayment schedules of the underlying loans. Borrowings from the U.S. Treasury are also reduced by authorized write-offs of Facilities Loan Program loans receivable. Interest is paid to Treasury based on a weighted average rate determined for each year.

Annual, Sick, and Other Leave

Annual leave is accrued as it is earned and the accrual is reduced as leave is taken. Each year, the balance in the accrued annual leave account is adjusted to reflect current pay rates. Annual leave earned but not taken, within established limits, is funded from future financing sources. Sick leave and other types of non-vested leave are expensed as taken.

Retirement Plans

The majority of ED employees participate in the contributory Civil Service Retirement System (CSRS), to which the Department makes matching contributions equal to seven percent of pay, or the Federal Employees Retirement System (FERS), offering a savings plan, which automatically contributes one percent of pay and matches any employee contribution up to an additional four percent of pay. In addition, for employees covered under FERS, the Department also contributes the employer's matching share for Social Security. ED does not report CSRS or FERS assets, accumulated plan benefits, or liabilities not covered by budgetary resources (unfunded liabilities), if any, applicable to its employees. Reporting such amounts is the responsibility of the Office of Personnel Management.

Net Position

Net position is the residual difference between assets and liabilities. It is composed of unexpended appropriations, invested capital, future funding requirements and donations. Unexpended appropriations are appropriations not yet expended, including undelivered orders.

Invested capital includes amounts advanced to guaranty agencies under sections 422(a) and 422(c) of the HEA for commencement of agency operations and making loan default payments to lenders, and acquisitions of capital assets. Net position has been reduced to reflect the excess of unfunded liabilities over any offsetting assets, which will require future funding. These unfunded liabilities include ED's liabilities for accrued leave, pre-credit reform loan guarantees, and actuarial liabilities not covered by available budgetary resources. Donations are relatively small contributions of funds which the Secretary has authority to accept and spend for certain purposes.

Comparative Data

Comparative data for the prior year have not been presented because this is the first year for which agency-wide principal financial statements are presented for ED.

NOTE 3 - FUND BALANCES WITH U.S. TREASURY

Fund balances with the U.S. Treasury at September 30, 1995 were as follows (in thousands):

	Obligated	Unobligated	Total
Forward Funded - Revolving Funds	$ 1,939,555	$ 7,579,417	$ 9,518,972
- Appropriations	16,021,632	4,406,537	20,428,169
Current Year - Appropriations	7,986,591	734,129	8,720,720
- Trust Funds	73	104	177
Total Appropriated Balances	$25,947,851	$12,720,187	$ 38,668,038
Deposit Funds			722,915
Budget Clearing Accounts			(15,701)
Total			$ 39,375,252

NOTE 4 - LOANS AND LOAN GUARANTEES

Analyses of credit program receivables, liabilities for loan guarantees and subsidy expenses are provided in the following sections.

A. Credit Program Receivables, as of September 30, 1995 were (in thousands):

	Defaulted Guaranteed Loans	Direct Loans	Facilities Loans
Loans Receivable	$17,049,007	$3,647,074	$683,023
Interest Receivable	2,673,315	28,205	11,559
Gross Program Receivables	$19,722,322	$3,675,279	$694,582
Less: Allowances	16,519,294	535,398	161,496
Net Program Receivables	$ 3,203,028	$3,139,881	$533,086

B. Liabilities for Loan Guarantees

Outstanding loan guarantees were approximately $93 billion at September 30, 1995. These loans were made by about 8,000 lenders and guaranteed by 41 guaranty agencies, operating in 54 states and territories. ED is contingently liable for guaranteed student loans made by lenders. These are estimated based on historical data received from guaranty agencies and lenders, and ED's cash flow data. The estimates are significantly affected by Treasury projections of future market interest rates that change the amount of special allowances to compensate lenders for program interest rates below market levels. The estimates are also affected by the types of schools attended (i.e., proprietary, two-year colleges, four-year colleges and universities, etc.) and the types of loans received (i.e., Stafford, Supplemental Loans for Students, Parents Loans for Undergraduate Students, etc.) by the student borrowers. ED's estimates, confirmed by an actuarial analysis, determined that ED's liabilities at September 30, 1995 for loan guarantees were approximately $12.9 billion as detailed below.

Liabilities for loan guarantees at September 30, 1995 were (in thousands):

	Pre-1992	Post-1991	Total
SHORT-TERM LIABILITIES -			
Covered by Budgetary Resources	$1,438,760	$3,366,171	$ 4,804,931
LONG-TERM LIABILITIES -			
Covered by Budgetary Resources	2,043,286	5,002,207	7,045,493
Not Covered by Budgetary Resources	1,056,039	-0-	1,056,039
Total Long-Term Liabilities	$3,099,325	$5,002,207	$ 8,101,532
TOTAL LOAN GUARANTEE LIABILITIES -			
Covered by Budgetary Resources	3,482,046	8,368,378	11,850,424
Not Covered by Budgetary Resources	1,056,039	-0-	1,056,039
Total Loan Guarantee Liabilities	$4,538,085	$8,368,378	$12,906,463

C. Subsidy Expenses

Loan guarantee subsidy expenses incurred during fiscal year 1995 were (in thousands):

Provision for Loan Defaults (Net)	$ 1,246,732
Provision for Interest Subsidies	2,798,731
Fees	(586,471)
Mandatory Administrative Expense	88,256
Total Current Year Estimate	3,547,248
Total Reestimates	(895,260)
Total Loan Guarantee Subsidy Expense	$ 2,651,988

Direct loan subsidy expenses incurred during fiscal year 1995 were (in thousands):

Loan Defaults (Net)	$ 291,031
Interest Subsidies	206,746
Fees, net (origination less payment for origination services)	(116,419)
Other Subsidy	43,161
Total Current Year Estimate	424,519
Add: Total Reestimates	11,613
Total Direct Loan Subsidy Expense	$ 436,132

NOTE 5 - GUARANTY AGENCY ADVANCES

Advances to guaranty agencies represent amounts advanced to guaranty agencies under sections 422(a) and 422(c) of the HEA for commencement of agency operations and making loan default payments to lenders.

The balances as of September 30, 1995 were (in thousands):

Advances to Guaranty Agencies	$40,164
Less: Allowance for Uncollectible Receivables	401
Advances to Guaranty Agencies, Net	$39,763

NOTE 6 - OTHER RECEIVABLES, NET

Non-credit program receivables consist of promissory notes and related interest receivables, other program receivables, audit receivables, reimbursables, recipient excess cash receivables, and receivables for monies owed to ED relating to travel, salary overpayments and other administrative items. These receivables are partially offset by an allowance derived from prior collection experience.

Non-entity receivables at September 30, 1995 were as follows (in thousands):

Gross accounts receivable	$56,096
Less: Allowance for uncollectible receivables	16,829
Net accounts receivable	$39,267

Entity receivables include delinquent and defaulted accounts receivable from credit and other programs that have been assigned to the Department for collection. The Other category, below, includes receivable amounts for about $2.1 million of overpaid Impact Aid awaiting offset and $8.6 million of accrued Pell interest.

These entity receivables are summarized as follows (in thousands):

	FFEL	Facilities	Other	Total
Loans Receivable	$5,011	$1,914	$10,739	$17,664
Less: Allowances	1,503	57	10,620	12,180
Net Program Receivables	$3,508	$1,857	$ 119	$ 5,484

NOTE 7 - BORROWING FROM U.S. TREASURY

A. The Emergency Unemployment Compensation Act

On September 30, 1992, the FFEL Program borrowed $2.09 billion from the U.S. Treasury in accordance with OMB instructions under the CRA on accounting for noncontractual modifications made to its loan guarantees. The noncontractual modifications were:

- The Emergency Unemployment Compensation Act of 1991 - authorized ED to continue collecting on defaulted loans through the Internal Revenue Service (offsetting income tax refunds); such authority had been due to expire in fiscal year 1994. The Act also authorized the use of wage garnishment as a collection tool for defaulted loans.

- The HEA Amendments of 1992 eliminated the statute of limitations on collection activities for certain student loans.

The FFEL Program will repay the borrowing, at an annual interest rate of 7.37 percent, with increased collections on defaulted loans resulting from the noncontractual modifications. During fiscal year 1995, the FFEL Program used collections to reduce this Treasury debt as follows (in thousands):

Borrowing from U.S. Treasury, Balance 9/30/94	$ 1,605,315
Payment on Outstanding Balance, 1995	(471,137)
Borrowing from U.S. Treasury, Balance 9/30/95	$ 1,134,178

The aggregate maturities of this debt, based on estimated collections on defaulted loans, for the years subsequent to September 30, 1995, are as follows (in thousands):

1996	$ 453,956
1997	326,149
1998	237,302
1999	116,771
Total	$1,134,178

B. Borrowing for Credit Programs, Repayments and Write-offs

Borrowings, repayments and write-offs were as follows (in thousands):

	Direct Loans	Facilities Loans	Total
Borrowings from U.S. Treasury, Balance 9/30/94	$ 433,207	$ 573,051	$ 1,006,258
New Borrowings During Fiscal Year 1995	4,868,340	24,156	4,892,496
Repayments	(234,825)	(53,357)	(288,182)
Write-offs	-0-	(233)	(233)
Borrowings form U.S. Treasury, Balance 9/30/95	$ 5,066,722	$ 543,617	$ 5,610,339

C. Interest Revenues and Expense

Interest expense, federal, was comprised of the interest accrued on borrowings from the Treasury and interest expense recognized to offset interest earned on uninvested funds.

Interest revenues and expense at September 30, 1995 is summarized as follows (in thousands):

	Direct Loan	FFEL	Facilities	Total
Interest Revenues	$340,120	$506,747	$ 977	$ 847,844
Interest Expense:				
Emergency Unemployment Compensation Act	-	118,314	-	118,314
Subsidy	-	506,747	1,626	508,373
Borrowings for Credit Programs	383,177	-	26,423	409,600
Total Interest on Loan Programs	$383,177	$625,061	$28,049	1,036,287
Other				45
Total Interest Expense				$1,036,332

NOTE 8 - SALARIES AND ADMINISTRATIVE EXPENSES

Salaries and administrative expenses by object classification at September 30, 1995 (in thousands):

Salaries and benefits	$299,148
Travel and transportation	11,916
Rent, communications and utilities	53,413
Printing and reproduction	15,717
Materials, supplies and equipment	21,738
Total salaries and expenses	$401,932

NOTE 9 - COMMITMENTS AND CONTINGENCIES

Guaranty Agency Matters

Guaranty Agency Reserve Funds

There are approximately $1,808,966 (in thousands) as of September 30, 1995 in federal reserves at the guaranty agencies. Guaranty agency reserves are available balances resulting from receipts of federal reinsurance payments, insurance premiums, agency share of collections on defaulted loans, investment income and administrative cost allowances; and payments of lender claims, operating expenses and federal reinsurance fees. The distribution of guaranty agency default collections during the year ended September 30, 1995 was 73 percent to ED; 27 percent to the agencies.

The Balanced Budget Down Payment Act, II provides that 1) the Secretary may not require return of guaranty agency reserve funds during fiscal year 1996, except after consultation with both the Chairman and Ranking Members of the House Economic and Educational Opportunities Committee and the Senate Labor and Human Resources Committee; and 2) any reserve funds recovered by the Secretary shall be returned to the Treasury for purposes of reducing the federal deficit. In accordance with these provisions, the guaranty agency reserves are reported as both a non-entity receivable asset and a payable to Treasury. We have also recognized some uncertainty regarding the collectibility of these reserves with an offsetting allowance of $180,897 (in thousands) for a net receivable amount of $1,628,069 (in thousands).

Possible Financial Difficulties of Guaranty Agencies

Education has assisted some guaranty agencies experiencing financial difficulties from time to time through advancement of funds and other means. No provision has been made in the principal statements for potential liabilities related to financial difficulties of guaranty agencies, because the likelihood of such liabilities occurring is uncertain and cannot be estimated with sufficient reliability.

Perkins Loans Reserve Funds

The Perkins Loan Program is a campus-based programs providing financial assistance to eligible postsecondary school students based on financial need. ED provides funds to participating schools to provide about 89 percent of the capital used to make loans to eligible students at 5 percent interest. The other 11 percent of program funding is provided by the institution. For the latest academic year (ended June 30, 1995), there were about 664,000 loans made, totalling about $972 million at 2,279 schools averaging $1,464 per loan.

The funding ratio had been 90/10 from the inception of the program through June 30, 1993. Then, for the academic years ended June 30, 1994 and 1995, the ratio for capital contributions was reduced to 85/15 and 75/25, respectively. The program operates at each school like a revolving fund with loan repayment amounts available to loan to other eligible students. The schools are accountable to the Department for the federal share of their Perkins Loan funds whether held by the school or loaned to participating students. At June 30, 1995, the Department's share of the Perkins Loan Program was about $5.8 billion. However, these funds are not reported in the principal statements of the Department because the extent to which they may be recoverable cannot be determined.

Claims-in-Process

In addition to the reported non-credit program receivables (see also Note 6), about $1.06 billion of non-credit program claims, for which collection probabilities have not yet been established, are being actively pursued as claims-in-process. The estimated net realizable value of claims-in-process at September 30, 1995 is about $29 million. However, much of these amounts consist of claims in various stages in the legal process and the ultimate value cannot currently be determined with reasonable certainty. Therefore, ED will not recognize these amounts in its financial statements until they are received or assured.

Borrower Class Actions

Education is involved in pending litigation challenging the enforceability of FFEL Program loans made to students who attended various trade schools that have closed. In most instances, a large percentage of the loans in question are in default and have been acquired by guaranty agencies and reimbursed by Education. Thus, Education has already incurred losses from payment of defaults. No provision has been made in the principal statements for any potential reductions in estimated future collections related to the outcome of these suits, since Education's potential loss exposure is uncertain and cannot be estimated with sufficient reliability.

Other Matters

ED is involved in various other claims and legal actions related to its programs, arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material effect on the principal statements of the Department.

NOTE 10 - SUBSEQUENT EVENTS

New Capital Financing Program

ED is establishing a Historically Black Colleges and Universities (HBCU) Capital Financing Program to facilitate construction and renovation of educational facilities by HBCUs. ED serves as guarantor for timely payment of principal and interest on bonds to be issued by a designated bonding authority, a private sector entity appointed by the Secretary. Bonds will be purchased by either private investors or the Federal Financing Bank. Proceeds of the bonds will be used for facilities loans to individual HBCUs. Each participating institution is obligated to deposit 10% of its loan proceeds into a common escrow fund that will be available for bond payments in the event of default by any participating institution. ED is contingently liable for repayment of bonds issued under this program. No loans were made as of September 30, 1995. As of March 1, 1996, loan applications for $37 million were in final stages of consideration, and other requests were in preliminary review.

United States Department of Education

CONSOLIDATING STATEMENT OF FINANCIAL POSITION
September 30, 1995
(Dollars in Thousands)

ASSETS	Federal Family Education Loan Program	Federal Direct Student Loan Program	All Other Activities	Department of Education Consolidated Balances
Entity Assets				
Intragovernmental Assets				
Fund Balances with U. S. Treasury	$ 8,647,575	$2,477,208	$28,250,469	$39,375,252
Governmental Assets				
Credit Program Receivable, Net	3,203,028	3,139,881	533,086	6,875,995
Advances to Guaranty Agencies, Net	39,763	--	--	39,763
Accounts Receivable, Net	3,508	--	1,976	5,484
Advances and Prepayments	--	--	74,587	74,587
Investments	--	--	19,148	19,148
Total Entity Assets	11,893,874	5,617,089	28,879,266	46,390,229
Non-Entity Assets				
Governmental Assets				
Guaranty Agencies' Reserve Receivable, Net	1,628,069	--	--	1,628,069
Other Receivables, Net	--	--	39,267	39,267
Total Non-Entity Assets	1,628,069	--	39,267	1,667,336
Total Assets	$13,521,943	$5,617,089	$28,918,533	$48,057,565

United States Department of Education

CONSOLIDATING STATEMENT OF FINANCIAL POSITION
September 30, 1995
(Dollars in Thousands)

LIABILITIES AND NET POSITION	Federal Family Education Loan Program	Federal Direct Student Loan Program	All Other Activities	Department of Education Consolidated Balances
Liabilities				
Liabilities Covered by Budgetary Resources				
Intragovernmental Liabilities				
Borrowing from U. S. Treasury	$ --	$5,066,722	$ 543,617	$ 5,610,339
Interest Payable to U. S. Treasury	--	--	12,049	12,049
Governmental Liabilities				
Liabilities for Loan Guarantees, Short-term	4,804,931	--	--	4,804,931
Liabilities for Loan Guarantees, Long-term	7,045,493	--	--	7,045,493
Guaranty Agencies' Reserve-Due to Treasury	1,628,069	--	--	1,628,069
Accrued Grant Liability	--	--	845,936	845,936
Accrued Contractual Services Liability	1,772	15,929	52,119	69,820
Accrued Salaries and Benefits	1,182	693	11,938	14,013
Other Accrued Liabilities	733	9,378	52,313	62,424
Total Liabilities Covered by Budgetary Resources	13,482,180	5,092,922	1,517,972	20,093,074
Liabilities Not Covered by Budgetary Resources				
Intragovernmental Liabilities				
Borrowing from U.S. Treasury	1,134,178	--	--	1,134,178
Governmental Liabilities				
Liabilities for Loan Guarantees, Long-term	1,056,039	--	--	1,056,039
Accrued Salaries and Benefits	1,550	1,171	17,477	20,198
Accrued Workers Compensation Liability	1,071	132	9,228	10,431
Total Liabilities Not Covered by Budgetary Resources	2,192,838	1,303	26,705	2,220,846
Total Liabilities	15,675,018	5,094,225	1,544,677	22,313,920
Net Position				
Unexpended Appropriations	--	524,167	27,357,516	27,881,683
Invested Capital	39,763	--	42,884	82,647
Future Funding Requirements	(2,192,838)	(1,303)	(26,705)	(2,220,846)
Donations	--	--	161	161
Total Net Position	(2,153,075)	522,864	27,373,856	25,743,645
Total Liabilities and Net Position	$13,521,943	$5,617,089	$28,918,533	$48,057,565

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United States Department of Education

CONSOLIDATING STATEMENT OF OPERATIONS AND CHANGES IN NET POSITION
For the Year Ended September 30, 1995
(Dollars in Thousands)

REVENUES AND EXPENSES	Federal Family Education Loan Program	Federal Direct Student Loan Program	All Other Activities	Department of Education Consolidated Balances
Revenues				
Interest , Non-Federal	$ –	$ 43,049	$ 39,882	$ 82,931
Interest, Federal	506,747	340,120	977	847,844
Other Revenue	–	–	316	316
Total Revenues	506,747	383,169	41,175	931,091
Expenses				
Guaranteed Loan Subsidy Expense	2,651,988	–	–	2,651,988
Direct Loan Subsidy Expense	–	436,132	–	436,132
Elementary and Secondary Education Grants	–	–	9,324,757	9,324,757
Postsecondary Education Grants	–	–	8,149,761	8,149,761
Special Education and Rehabilitative Services Grants	–	–	5,580,045	5,580,045
Other Grants	–	–	2,035,320	2,035,320
Interest Expense	625,061	383,177	28,094	1,036,332
Salaries and Administrative Expenses	33,122	31,058	337,752	401,932
Contractual Program Expenses	159,098	97,657	410,506	667,261
Bad Debt and Write-offs	5,079	–	(2,160)	2,919
Other Expenses, Net	–	–	559	559
Total Expenses	3,474,348	$48,024	25,864,634	30,287,006
Net Operating Activity	(2,967,601)	(564,855)	(25,823,459)	(29,355,915)
FFLEP mandatory admin expense funded by Direct Loan approp	220,728	(220,728)	–	–
Operating Activity funded by appropriations	$(2,746,873)	$ (785,583)	$(25,823,459)	$(29,355,915)
CHANGES IN NET POSITION				
Net Position , Beginning of Year	$(4,042,534)	$ 203,226	$26,505,056	$22,665,748
Operating Activity funded by appropriations	(2,746,873)	(785,583)	(25,823,459)	(29,355,915)
Plus (Minus) Non-Operating Changes				
Appropriated Funds Received	5,321,855	1,105,221	26,847,558	33,274,634
Appropriated Funds Returned	(780,523)	–	(114,517)	(875,040)
Appropriations, Transferred From (To) Others	75,000	–	(40,782)	34,218
Net Position, End of Year	$(2,153,075)	$ 522,864	$27,373,856	$25,743,645

United States Department of Education

CONSOLIDATING STATEMENT OF CASH FLOWS
For the Year Ended September 30, 1995
(Dollars in Thousands)

NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES	Federal Family Education Loan Program	Federal Direct Student Loan Program	All Other Activities	Department of Education Consolidated Balances
Operating Cash Provided				
Default Claims Collected	$ 2,013,058	$ –	$ –	$ 2,013,058
Loan Origination and Other Fees	1,065,732	81,105	57	1,146,894
Interest Income, Federal	506,747	296,971	977	804,695
Interest and Penalty Income, Non-Federal	4,102	14,498	33,208	51,808
Other Operating Cash Provided	1	–	294	295
Total Operating Cash Provided	3,589,640	392,574	34,536	4,016,750
Operating Cash Used				
Interest and Penalties, Non-Federal	(2)	(8)	(44)	(54)
Interest, Federal	(118,312)	(383,169)	(24,512)	(525,993)
Default Claim Payments	(2,521,172)	–	(1)	(2,521,173)
Interest Subsidy Payments	(2,185,647)	–	–	(2,185,647)
Special Allowance Payments	(615,496)	–	–	(615,496)
Mandatory Administrative Expenses	(37,134)	(220,728)	–	(257,862)
Grants, Advances, and Contributions	–	–	(25,014,693)	(25,014,693)
Salaries and Benefits	(25,655)	(19,116)	(263,911)	(308,682)
Rent, Communications, and Utilities	(3,657)	(4,439)	(45,348)	(53,444)
Contractual Program Services	(156,919)	(83,685)	(417,684)	(658,288)
Printing and Reproduction	(635)	(3,000)	(12,083)	(15,718)
Travel and Transportation	(2,171)	(975)	(8,808)	(11,954)
Materials, Supplies, and Equipment	(1,962)	(2,838)	(16,859)	(21,679)
Guaranty Agency Collection Fees	(285,376)	–	–	(285,376)
Other Operating Cash Used	–	(3,750)	(835)	(4,585)
Total Operating Cash Used	(5,954,158)	(721,708)	(25,804,778)	(32,480,644)
Net Operating Cash Used by Operating Activities	(2,364,518)	(329,134)	(25,770,242)	(28,463,894)

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United States Department of Education

CONSOLIDATING STATEMENT OF CASH FLOWS
For the Year Ended September 30, 1995
(Dollars in Thousands)

	Federal Family Education Loan Program	Federal Direct Student Loan Program	All Other Activities	Department of Education Consolidated Balances
CASH PROVIDED (USED) BY INVESTING ACTIVITIES				
Collection of Advances	$ –	$ 750	$ –	$ 750
Loan Repayments Received	–	29,397	44,450	73,847
Loan Disbursements	–	(3,256,029)	(11,911)	(3,267,940)
Net Cash Provided (Used) by Investing Activities	–	(3,225,882)	32,539	(3,193,343)
CASH PROVIDED (USED) BY FINANCING ACTIVITIES				
Appropriated Funds Received	5,321,855	1,105,221	26,847,558	33,274,634
Transfer of Cash To/From Others, Net	75,000	–	(40,782)	34,218
Appropriated Funds Returned	(760,523)	–	(114,517)	(875,040)
Net Appropriations	4,636,332	1,105,221	26,692,259	32,433,812
Repayments to U.S. Treasury For Borrowings	(471,137)	(234,825)	(53,357)	(759,319)
Borrowing from U.S. Treasury	–	4,868,340	24,156	4,892,496
Net Cash Provided by Financing Activities	4,165,195	5,738,736	26,663,058	36,566,989
Net Cash Provided by Operating, Investing, and Financing Activities	1,800,677	2,183,720	925,355	4,909,752
Fund Balances with U. S. Treasury: Beginning of Year	6,846,898	293,488	27,325,114	34,465,500
Fund Balances with U. S. Treasury: End of Year	$8,647,575	$2,477,208	$28,250,469	$39,375,252

United States Department of Education

CONSOLIDATING STATEMENT OF CASH FLOWS
For the Year Ended September 30, 1995
(Dollars in Thousands)

	Federal Family Education Loan Program	Federal Direct Student Loan Program	All Other Activities	Department of Education Consolidated Balances
RECONCILIATION OF NET OPERATING ACTIVITY BEFORE APPROPRIATIONS TO NET CASH USED BY OPERATING ACTIVITY				
Operating Activity funded by appropriations	$(2,746,873)	$ (765,563)	$(25,823,459)	$(29,355,915)
Adjustments to Reconcile Net Operating Activity to Net Cash Used by Operating Activities:				
Allowance for Subsidy	–	506,026	1,043	507,069
Changes in:				
Decrease (Increase) in Credit Program Receivable, Net				
Defaulted Guaranteed Loans	301,843	–	–	301,843
Direct Loans	–	(66,551)	(1)	(66,552)
Facilities Loans	–	–	(14,032)	(14,032)
Decrease in Advances to Guaranty Agencies, Net	1	–	–	1
Decrease (Increase) in Accounts Receivable, Net	(2,214)	–	91	(2,123)
Increase in Other Receivables, Net	–	–	(39,267)	(39,267)
Decrease in Advances and Prepayments	–	–	59,808	59,808
Increase in Interest Payable to U. S. Treasury	–	–	1,910	1,910
Increase in Liabilities for Loan Guarantees	61,523	–	6	61,529
Increase in Accrued Grant Liability	–	–	16,501	16,501
Increase (Decrease) in Contractual Services Liability	1,772	16,098	(5,732)	12,138
Increase (Decrease) in Accrued Salaries and Benefits	(1,092)	792	(10,680)	(10,980)
Increase in Other Accrued Liabilities	405	–	42,394	42,799
Increase in Workers Compensation Liability	114	66	1,179	1,379
Net Adjustments	362,356	456,449	53,217	892,021
Net Cash Used By Operating Activities	$(2,384,518)	$(329,134)	$(25,770,242)	$(28,463,894)

United States Department of Education

CONSOLIDATING STATEMENT OF CASH FLOWS
For the Year Ended September 30, 1995
(Dollars in Thousands)

	Federal Family Education Loan Program	Federal Direct Student Loan Program	All Other Activities	Department of Education Consolidated Balances
Supplemental Schedule of Noncash Investing Activities				
School disbursements included in accounts payable	–	$(18,450)	$ –	$(18,450)
Writeoff of Principal Adjustments/Cancellations	–	(337)	(496)	(833)
Interest Capitalized to Principal	–	1,190	–	1,190
Total Supplemental Schedule of Noncash Investing Activities	–	$(17,597)	$(496)	$(18,093)

Department's Response to Auditor's Report

and

Auditor's Evaluation of Department Comments

UNITED STATES DEPARTMENT OF EDUCATION

WASHINGTON, D.C. 20202-_____

AUG 6 1996

Steven A. McNamara
Assistant Inspector General
for Audit Services
U.S. Department of Education
Washington, DC 20202

Dear Mr. McNamara:

This is in response to your request for comments on the draft audit report on the first Department of Education (ED) agency-wide financial statements issued. As noted, these statements and the related audit are for the fiscal year ended September 30, 1995, the year prior to the first year required by the Government Management Reform Act of 1994 (GMRA).

Many of the audit report issues relate to longstanding problems of the Federal Family Education Loan (FFEL) Program. Those problems stem mostly from the structure of this program which causes the Department to depend on guaranty agencies and lenders to provide student loan data. ED's relationship with these independent entities is not structured to give the Department sufficient leverage to assure the adequacy of guaranty agency and lender operations that affect FFEL Program management and cost. This dependency on outside entities to provide needed program data has made it difficult to cure the errors and missing data discussed in this and previous audit reports. However, the Department will continue to work closely with the appropriate FFEL Program entities to improve the quality of the data in its FFEL Program systems.

While we agree with the need to further improve the FFEL Program data, we believe the reported FFEL Program liability for loan guarantees of $12.9 billion is reasonable. This amount is based on an independent actuarial analysis of available student loan data in conjunction with our actual cash flow experience over the past four years. During this period of time, our estimated liability amounts have been consistently conservative compared with our actual cash flow experience.

The audit report stated that we reported FFEL Program defaulted loans receivable held by guaranty agencies at an amount $888 million in excess of guaranty agency records. However, we reduced our general ledger accounts receivable balance by this amount before preparing the final financial statements. This adjustment was made because our FFEL Program subsidiary systems, which are not yet fully integrated with our general ledger, did not properly post guaranty agency collections to the general ledger. Therefore, net receivables for defaulted loans held at guaranty agencies, as adjusted, are correctly reflected on our financial statements and agree with the amounts that the guaranty agencies reported to us.

Since passage of the Chief Financial Officer's Act of 1990, we have continued to make improvements in the operations of the FFEL Program. These program improvements were made in the areas of recruiting and training high quality program and financial managers, further implementation of the National Student Loan Data System (NSLDS), developing Education's Centralized Administrative Processing System (EDCAPS), and further enhancements to gatekeeping, guaranty agency and lender oversight functions. ED has also continued to transition student loans from guaranteed to direct lending, which we believe is more conducive to sound program and financial management because the Department has direct access to student loan data.

Another issue raised in the audit report was the $183 million difference of reported funds in excess of Treasury's balances. This difference, representing a small percentage of our $39 billion Fund Balances with Treasury at September 30, 1995, results primarily from our lack of integrated accounting and financial management systems. We expect this issue to be fully resolved by the time EDCAPS, our new integrated financial management system, is implemented in late 1997.

With respect to the other issues raised in the report, we are in general agreement with most of these issues. However, before developing a comprehensive corrective action plan, we need to further analyze the specific audit report recommendations to determine the best way to proceed toward achieving the desired results. We plan to do so promptly and to take all appropriate corrective actions as soon as possible.

Thank you for the opportunity to comment on the draft report. The Department is committed to continuing efforts to improve management over departmental programs and to better serve program participants and taxpayers. If you have any questions on our approach to addressing issues raised in the audit, please contact Gloria Jarmon, Office of the Chief Financial Officer, at (202) 401-0561 or Linda Paulsen, Office of Postsecondary Education, at (202) 708-4664.

Sincerely yours,

Mitchell L. Laine
Acting Chief Financial Officer

David A. Longanecker
Assistant Secretary for
Postsecondary Education

Office of Government Services
1301 K Street N.W., 800W
Washington, DC 20005-3333

Telephone 202 414 1000

Price Waterhouse LLP

PW Evaluation of Department Comments

To the Inspector General
U.S. Department of Education

We received comments from Education on our draft report. The Department believes its $12.9 billion liability for Federal Family Education Loan Program (FFELP) loan guarantees is reasonable. They believe it is reasonable because Education engaged an "independent"[1] actuarial analysis using "available student loan data in conjunction with our actual cash flow experience over the past four years." The Department also states that its estimated liability amounts "have been close to and consistently conservative compared with our actual cash flow experience."

We disclaimed an opinion on Education's consolidated financial statements principally because we believe shortcomings in loan data were not overcome by the actuarial analysis. Moreover, the severity of the data shortcomings, particularly with respect to data on loan collections, meant that the actuarial analysis had to apply a series of assumptions about how defaulted loans were collected. For example, Education had certain collection data on individual loans since 1990. But this data was either inconsistent, in that it measured yearly loan collections in some cases and cumulative loan collections in others; or, when aggregated, it was materially different from cash flow figures reported in Education's financial statements. The actuarial contractor made the assumption that, despite its flaws, the existing data reasonably reflected the pattern by which defaulted loans were collected because it believed the effect of any data errors would be immaterial. It was also assumed that the difference between dollar collections reported in the financial statements and aggregate collections contained in the data base could be proportionally allocated to all loans, since there was no other way to apply unallocated collections to individual loans. We do not believe either of these assumptions have adequate support. Further, the number of other assumptions the contractor had to make to compensate for missing or questionable data introduces

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- We do not believe this review was independent as that term is defined by generally accepted auditing standards or by *Government Auditing Standards*, issued by the Comptroller General of the United States. In its report, the contractor states, "...we performed the procedures enumerated in this report solely to **assist** management in estimating its [FFELP] liability..." And further, the contractor states, "The procedures we performed, as well as the assumptions, methodologies and limitations **were developed in conjunction with and approved by ED management**." [Emphasis added.]

additional uncertainties into the liability estimate. As a consequence, we cannot concur with the Department's assertion that its $12.9 billion aggregate loan guarantee liability is reasonably stated.

With respect to the Department's contention that its estimated liability amounts have been close to and consistently conservative compared to its actual cash flow experience, we were provided with information in support of this statement, which we have summarized in Table 1:

Table 1 **(Dollars in Thousands)**
Loan Guaranty Liability Comparison Provided By the Department
Summary Comparison of Estimated Liabilities and Actual Expenditures

Analytical Component	For the Fiscal Year Ended September 30,			
	1992**	1993**	1994**	1995*
Estimated Liability	$6,119,943	$4,894,512	$5,536,702	$4,110,080
Actual Expenditures	$4,503,596	$4,311,348	$3,787,647	$3,060,179
Variance	$1,616,347	$583,164	$1,749,055	$1,049,901
Percent Variance	26%	12%	32%	26%

* From an analysis by Education's actuarial contractor; short-term component only.
** From liability analysis prepared by Education; short-term component only.

We believe some observations about this information are necessary. First, the information relates only to components -- predominantly short-term components -- of the aggregate loan guaranty liability. For example, for fiscal year 1995, the table shows an "estimated" liability of $4.1 billion and an "actual" figure of $3.1 billion. These are portions of the aggregate 1995 liability of $12.9 billion. Second, the table indicates that the "estimated" component of the liability exceeded "actual" by $1.7 billion in 1994 and $1.6 billion in 1992. Presumably, this is the basis for the Department's assertion that it has been "consistently conservative" in its estimates. However, there is no evidence to indicate whether this variance is attributable simply to a timing shift between the short- and long-term components of the aggregate loan guarantee liability, or if it means that the short-term component of the portfolio is performing better than originally estimated. In any event, we are required under generally accepted auditing standards to determine whether the estimate is reasonable within a tolerable range, not whether it is consistently conservative.

Our report cited an unexplained difference of $888 million between the loan receivable balance in Education's accounting records and amounts reported to Education by

guaranty agencies. The Department believes it has adequately explained this difference and has adjusted its accounting records such that they now equal amounts reported by guaranty agencies. The Department states that the difference arose because of posting problems for collections in its general ledger system. We were informed that the analysis that made this determination was performed in 1992, but no documentation could be provided to support it. In the absence of this evidence, it is not possible for us to conclude that writing off the $888 million difference and adjusting to guaranty agency records was proper and supportable.

The Department generally agreed with our remaining findings and, after further analysis, they intend to develop a more comprehensive action plan to address them. We appreciate the opportunity to provide comments on the Department's response.

Very truly yours,

Price Waterhouse LLP

Washington, D.C.
August 16, 1996

Report Card

The Department values your input and perspective in improving this document. In an effort to make this report more understandable and useful to our customers in the future, we invite you to comment on your interest and satisfaction with this report.

Content	A	B	C	D	F
Overview of Department and Programs	____	____	____	____	____
Current Year Highlights and Performance	____	____	____	____	____
- Programs	____	____	____	____	____
- Financial	____	____	____	____	____
- Process Improvement	____	____	____	____	____
- Reporting Requirements	____	____	____	____	____
Relevance to Your Needs					
- As a taxpayer	____	____	____	____	____
- As a learner	____	____	____	____	____
- As a _____	____	____	____	____	____

Report Tone and Perspective					
Balanced View of Department and Progress	____	____	____	____	____
Ease of Understanding	____	____	____	____	____
Other _____	____	____	____	____	____

Rating Scale:

A=Excellent, B=Good, C=Average, D=Below Average, F=Unsatisfactory

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Other Comments:

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Mitchell L. Laine
Acting Chief Financial Officer
U.S. Department of Education
600 Independence Avenue, S.W.
Washington, D.C. 20202

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